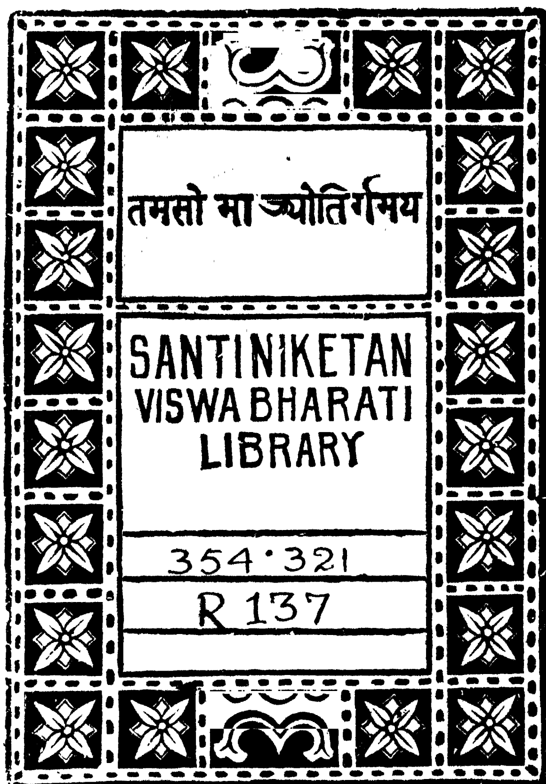


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INTRODUCTION TO
MONEY, EXCHANGE & BANKING
With Special Reference to India

BY

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PREFACE TO THE EIGHTH EDITION

It is gratifying to note that the seventh edition was exhausted much sooner than was anticipated. In the present edition all figures have been made up-to-date and text thoroughly revised. It is hoped that the present edition will enjoy the same patronage as its previous ones.

On account of the heavy demand a Hindi edition of the book has also been issued.

DELHI R. N. MATHUR
1-7-55

PREFACE TO THE FIRST EDITION

The first appearance of a book like this might demand a few words by way of justification. My long and intimate connection with the students of the University of Delhi made me realise the handicaps which they, in grasping the subtle and involved principles of currency and by exchange, constantly laboured under. The market has already been glutted with numerous works on the subject some of which are undoubtedly excellent but most of the books extant in the market have been found inadequate for one or more of the following reasons. Either they are too restricted in scope and treatment of one of these subjects with the consequent narrowness of approach, or they are too difficult in language or their data and figures are not, at least in some important respects, the most up-to-date. The dearth of a single comprehensive book treating of the intricate problems of money, exchange and banking impelled me to make this maiden venture in authorship. It cannot be denied that the desideratum of a volume of this description dealing with the rudiments of currency and banking with suitable reference to Indian economic life has been long felt.

Economics has made great and rapid strides of late but the complexity of the subject has compelled its full result to be unexplored and unmeasured. Interest in banking and currency has perhaps never been more vital than it is today. Even in India, conditions have changed appreciably and fast since the Report of the Banking Enquiry Committee, the enactment of the Reserve Bank Act and the consequent inauguration this year of the Reserve Bank which is destined to play an important part in the future of Indian currency, exchange and banking.

Since the subject of currency is in perpetual flux and reflux, students are obsessed with its problems so much so that sometimes they have been found to have made 'confusion worse confounded.' I have, therefore, strained every nerves to facilitate students' apprehension of the principles and problems of currency. My prime objective has been to elucidate the intricate problems and principles of currency with copious, familiar and forceful illustrative references. In fact, to present this subject matter in a logical, ordered and pellucid sequence has alone been the *raison d'etre* of the publication of this book.

I must apologise in advance if some of my junior readers find the language a little stiff at places. Obviously, in a discussion of such complicated and abstruse a subject as this, a certain amount of technicality could not be avoided with the best will in the world to do so. Every effort has, however, been made to keep down the number of expressions not intelligible at a glance and it is hoped that they are no more than the irreducible minimum. Even those who feel this difficulty will find it vanishing fast after a close reading of the first few chapters.

An attempt has been made to make the book comprehensive so that it will be found to cover the syllabus of many universities of Northern India and it is confidently hoped that it will serve as a *vade mecum* to all students of Economics, particularly those grappling with the tense problems of currency and banking. To render the book an auxiliary vehicle for the students in mastering the subject, succint but comprehensive summaries have been appended to each of the chapters. Questions of varied types, culled with care from the examination papers of various universities, have been incorporated in the body of the book with the evident purpose that students might consult them and derive benefit especially at a time when they are revising or trying to refresh their memories in a hurry. I shall consider my pains amply rewarded if the book will prove to be of some assistance to students in grasping the complexity of the subject in a clearer focus.

I take this opportunity of thanking kind friends and all those who have helped me in one way or the other. Foremost of these should be mentioned Mr. K. C. Nag, Reader and Head of the Department of Economics at the University of Delhi, Mr. Hirde Narain, Head of the Department of Economics, Hindu College, and Mr. B. N. Ganguli, Reader in Economics. To Prof. Nag's constant encouragement and kind attention I owe and shall always owe much ; Prof. Hirde Narain and Prof. B. N. Ganguli have very kindly looked at the manuscript and given valuable suggestions from time to time. Mr. M. A. Jan, Librarian of the Central Secretariat Library, has been kind enough to offer me facilities of all kinds. His unfailing courtesy and indefatigable assistance are unforgettable. Lastly, Mr. Loke Ram Sharma, B. A., has been of great help to me in preparing the index. I sincerely and cordially offer my thanks to all of these gentlemen.

Any constructive criticisms and suggestions conducive to the improvement of the book either in respect of the plan or scope or matter will be heartily welcomed and appreciated.

In fine, I would like to express myself in the immortal couplet of the poet :—

"And what is writ is writ.—
Would it were worthier !" (Byron)

HINDU COLLEGE, DELHI.
2nd December, 1935. RAJ NARAIN MATHUR.

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CHAPTER 1

THE MECHANISM OF EXCHANGE

Definition of Barter. In primitive states of society wants are few and easily satisfied. Everybody produces just what he requires, but if he produces more, he can easily exchange it with the surplus product of another man's labour. This system of exchange of commodities for commodities or services is called *"Barter"*.

Defects of Barter. As wants increase, however, and new methods of satisfying them are discovered, barter becomes a very inconvenient process—quite unsuited to a civilised society based on complex division of labour. Barter is in the nature of a double act which pre-supposes agreement between two individuals. When the number of exchangeable goods increases it becomes less likely that a case should arise of the meeting of two people each of whom has a superfluity of *just those goods* of which the other stands in need. For example, a man with a horse and wanting a coat may never get it unless he finds somebody who is prepared to give him a coat *and* accept his horse in return. Even if two people could be found whose disposable possessions mutually suit each other, in the absence of a common measure of value, at what rate is the commodity to be exchanged for another ? It is highly improbable that the owner of the horse would regard it as exactly equivalent to the coat, and if he thinks that his property is more valuable, exchange would be impossible because a portion of the horse would be of no use to the owner of the coat. Hence, three inconveniences attach to the practice of simple barter, namely, the improbability of coincidence between persons wanting and possessing, the complexity of exchanges which are not made in terms of one single substance, and the need of some means of dividing and distributing valuable articles.

Origin and Definitions of Money. In order to avoid these difficulties of barter it is necessary to decide upon an *intermediate* commodity which would always be accepted in exchange for goods and services and which would form a basis for the measurement and comparison of the values of all other commodities. Such a commodity is called "Money". It may be defined as "anything which is widely accepted in payment for goods or in discharge of other kinds of business obligations."[1] Marshall has defined money as "All those things which are (at any time and [illegible]) generally current without doubt or special enquiry as a mea[illegible] purchasing commodities and

1 Robertson—*Money*, pp. 2-3.

services and of defraying expenses."[1] Cole has recently defined money simply as purchasing power—something which buys things.[2] This view is supported by other modern writers, especially English and American, who have used the word money in the ordinary, everyday sense of currency notes, coins and the bank balances on which we can draw by cheques.[3] These definitions are, however, too inclusive for they include even the media of exchange which have a very narrow area of circulation and which may be refused, such as cheques and bills of exchange. Moreover, these documents merely represent certain *claims* over goods. But claims are not goods; they are only means of obtaining disposal over goods. They themselves are not valued directly, but indirectly; their value is derived from that of the economic goods to which they refer. In order to clarify this idea, Mises has distinguished between *money* and *money-substitutes*—the expression "money-substitutes" being used for all "those objects which are employed like money in commerce but consist in perfectly secure and immediately convertible claims to money."[4] While he does not object to money-substitutes being included in the single concept of money, he has himself preferred to treat the two forms of money separately.

Characteristics of Modern Money. The most remarkable feature of modern money is that its value in itself bears no relation to what it will buy—that is, to its value in a transaction. A rupee note, for instance, has no value in itself. It is merely a measuring unit in people's minds—a unit on which they roughly, though not universally or exactly, agree at any one time. That it can be exchanged for a certain amount of goods notwithstanding the fact that its own value is practically nothing is due to the fact that it is "legal tender". The law requires that, having once valued his goods at a rupee, the seller may not refuse to receive a rupee note in settlement of his charge. Similarly, a bank balance has no intrinsic value whatever. It is nothing but an entry in a book and the cheque drawn upon it is only an instruction to the bank to pay. A cheque in the possession of a man has no value. If it is presented to the bank for encashment its value is equal to the money written on it but, as is more often the case, it is deposited in account, the amount of the payee's balance is increased by the amount by which the drawer's account is reduced. When the drawer of the cheque and the payee are customers of different banks, there may be a transfer from one bank to the other of the value of the cheque. In any case, the payee has so much more

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1 *Money, Credit and Commerce*—p. 13. Crowther has defined money "as *anything* that is *generally acceptable* as a means of exchange (i. e., as a means of settling debts) and at the same time acts as a measure and as store of value".—*An Outline of Money*, p. 350.

2 G.D.H. Cole—*What Everybody Wants to Know About Money*, p. 21. For a still more illuminating discussion of the meaning of money read Johnson—*Money and Currency*, pp. 6-7.

3 Curtis and Townshend—*Modern Money*, p. 1.

4 Ludwig von Mises—*The Theory of Money and Credit*, pp. 52-54.

claims, and the drawer so much less, over legal tender money. Thus business is carried on by setting off debts against one another. In such a system the supply of money can be easily varied at will and thus cause widespread distress and dislocation in trade and industry. Hence, modern money has to be properly "managed" in the best interests of the community. The purpose of this management is not only to adjust the supply of money to the requirements of business but also to speed up its use when it is too slow and to check it when it is too fast as well as to retain the confidence of the people in money as a means of settling their debts by maintaining stability in its value. "The basic task is to keep money scarce enough to be valuable and abundant enough to finance production and employment".[1]

Functions of Money. Money performs a fourfold function. It is, in the first instance, a *medium of exchange.* It enables a person to *buy* and *sell* directly what he wants. He parts with money when purchasing and gets money when selling goods and services. A careful study of the evolution of money will show clearly that the primary cause of the creation of money was the necessity of overcoming the great difficulties of direct exchange or barter difficulties which grew progressively as the exchangeable commodities increased in number. Historically, therefore, to act as a general medium of exchange appears to be not only an essential function but the *only* essential one and other functions as having been derived from it. Secondly, it serves as a *common means of payment* because people accept it without hesitation in the hope that others will take it in turn. Thirdly, it is a *common measure of value* or, strictly speaking, a *common denominator* of relative values. Thus it avoids the difficulty of remembering the cross-relationships of millions of articles of varying quality and fineness. If, for example, we know that wheat sells at Rs. 6 a maund, corn at Rs. 3 and straw at Rs. 2 a maund, we know that the value of wheat is twice that of corn and thrice that of the straw. Every article bought or sold can now be valued in terms of the common unit and the value of the commodity measured in terms of money constitutes its *price.* Fourthly, it serves as a *standard of deferred payments.* Contracts, including loans, are usually made in terms of money. This is because people believe that the value or purchasing power of money is not likely to change much during the period of the contract. If there was no money, lending of all kinds would be much restricted owing to the risk that the value of the commodity, in terms of which the loan was made, would change considerably. Lastly, it is a means of *storing* value.[2] Perishable commodities cannot be stored as they lose in value with time. Storing of bulky commodities is also difficult. With the introduction of money one can transform his savings in money and with money he can readily purchase both goods and services. Thus "it sub-divides and distri-

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1 Curtis and Townshend—*Modern Money*, p. 24.

2 Benham has used the phrase "a liquid asset" instead of "a store of value." *Economics*, pp. 337 and 341.

butes property and lubricates the action of exchange."[1] It may perhaps be easier to remember the functions of money by the following rhyme :—

"Money's a matter of functions four :
A medium, a measure, a standard and a store."

Now, it should be quite possible to use one substance as a medium of exchange, a second as a measure of value, a third as a standard of value and a fourth as a store of value. "In buying and selling we might transfer portions of gold; in expressing and calculating prices we might speak in terms of silver; when we wanted to make long leases we might define the rent in terms of wheat, and when we wished to carry our riches away, we might condense it into the form of precious stones." But it is obviously convenient to select a single substance to perform all the functions of money.

Characteristics of Good Money. We have seen that money is a visible assurance that a claim upon the society will be duly honured. We take money for our goods and services because we are convinced that others will take it from us in return for their goods and services. Anything with regard to which we have this conviction is money. It may be a piece of metal bearing the stamp of pubilc authority or merely a written promise to pay an equivalent amount of metal or any other suitable substitute. Primitive societies probably used crude implements of stone and metal as money but instances are not rare when slaves, oxen, sheep, rings, shells, skins etc.,[2] were used and are still being used as medium of exchange. In advanced communities, however, these crude articles have been replaced by precious metals. They possess *utility* and *value*. "Nothing which is not itself valuable can serve as a medium of exchange. No one would consciously give away commodities of value for a medium of exchange which was notoriously lacking in value and which he might possibly be obliged to hold for a time. Otherwise, the whole purpose of exchange would be defeated since for a worthless medium of exchange one could not obtain other goods."[3] Their *beauty* and their quality of being easily fashioned make them *universally desirable* as raw material for ornaments and for other articles of all kinds, apart from any question as to their utility. They are *durable*, that is, possess an almost unlimited power of resistance to the destructive influence of water, air, fire etc. This quality enables them to be easily stored for any length

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1 Jevons—*Money and the Mechanism of Exchange*, p. 15.

2 Schurtz quotes from Mollien's book on his journey in the interior of Africa the following table of values for Bondu in Western Sudan :

1 slave = 1 double-barrelled gun and two bottles of powder.
,, ,, = 5 oxen.
,, ,, = 100 pieces of cloth.
1 string of glass beads = 1 gourd bottle of water.
,, ,, ,, ,, ,, = 1 measure of milk.
,, ,, ,, ,, ,, = 1 armful of hay.
,, ,, ,, ,, ,, = 1 measure of millet.

—Helfferich's *Money*, Vol. I, p. 9.

3 Laughlin—*The Principles of Money*, p. 18.

of time without risk of change in their substance. The composition of the precious metals is absolutely *uniform*. It does not vary from piece to piece and is independent of the place of origin. The homogeneity of precious metals affords complete protection against the circulation of false coins. A still further quality of the precious metals, which is essential to their function as money, is their unlimited *divisibility*. They can be divided with exactness into smaller parts and can again be melted together into a whole, at a small cost. Thus there is no limit to the magnitude of the values which can be represented by the precious metals in contrast with commodities such as shoes and cattle which are, by nature, indivisible or with commodities which can only be divided with loss of value as is the case of diamonds. The *malleability* of precious metals renders them particularly adaptable to take impressions, and this makes it possible for individual pieces to be authoritatively certified in regard to their fineness and weight. The precious metals are comparatively *scarce*. Their *large value in small bulk* contributes to the easy transfer of money from place to place and gives it a substantially uniform value in all parts of the world at the same time. Finally, we must mention that specially important property of precious metals—relative *stability of value*—which follows from some of the properties mentioned already. Their value is normally free from fluctuations caused by excess or shortage of supply and from destruction through wear and tear.

Some of the qualities enumerated above can be met with in other commodities in an equal or even higher degree. For example, diamonds possess high intrinsic value but they are more destructible and very much less plastic than the precious metals. It has so far been found possible to make small diamonds out of large ones but not one large diamond out of a number of small ones. Such a happy and complete combination of these qualities is to be found in gold and silver that one is not surprised that they constitute universal money independently of all conventions and law.

Advantages of Money. In modern civilised society inconveniences of the primitive method of exchange are wholly unknown and might almost seem to be imaginary. The modern economic system is founded on the principle of production for a market. Division of labour has caused a wide gulf between the products of the individual's labour and his requirements. Money alone makes possible the exchange of goods and services in the degree required by our economic system and has, therefore, forced barter very much into the background. From the entrepreneur down to the smallest peasant farmer, all sell their surplus products for money. The workman places his labour at the disposal of the employer for a money wage ; the transfer of wealth and purchasing power takes place in money. Thus it is "an indispensable link in the social chain of the market; an indispensable part of the mechanism which regulates an otherwise planless society".[1] Money increases production

1 Erich Roll—*About Money*, pp. 33-34.

by facilitating exchange of commodities by promoting specialisation. It gives necessary mobility to capital and thus helps the concentration of capital in the hands of those who are best able to utilise it in an effective manner. It makes capital flow from places where it is less productive to places where it can be employed profitably. It has been responsible for the growth of social and political freedom by substituting freedom of contract and competition for custom and status. It has also broken up the exclusiveness and isolation of towns and villages and has thus created national and political solidarity. In short, in the whole process of production and distribution, money enters as a connecting medium between the different members of a society and between different communities. "Accustomed from our earliest years to the use of money, we are unconscious of the inestimable benefit which it confers upon us ; and only when we recur to altogether different states of society can we realise the difficulties which arise in its absence."[1] It is interesting to note in this connection that the service of money to society is similar in character to that of the roads and other means of communication. This fact was pointed out by Adam Smith when he declared : "The gold and silver money which circulates in any one country may very properly be compared to a highway which, while it circulates and carries to market all the grass and corn of the country, produces not a single pile of either."[1]

The advantages of money are not enjoyed by the producers only. Since money permits the processes of production and distribution to function more effectively it indirectly benefits the consumers also. If the production and distribution of goods were complicated by a cumbersome system of counting, the cost of goods would be raised because more time would then be spent in arriving at a proper course of action in producing and distributing goods. A further effect of this method would be to reduce the variety and volume of goods offered for sale and thereby to lower the standard of consumption. Another advantage of a money economy to the consumer is that a simplification of counting also expedites the task of comparing the costs and values of the various goods offered for sale. Careful and successful buying, whether by the consumer or by the

1 Jevons—*Money and the Mechanism of Exchange*, p. 2.

2 Robertson explains the advantages of money thus : "It enables man as consumer to generalise his purchasing power, and to make his claims on society in the form which suits him most. The existence of a monetary economy helps society to discover what people want and how much they want it, and so to decide what shall be produced, and in what quantities, and to make the best use of its limited productive power...It helps each member of society to ensure that the *means* of enjoyment to which he has access yield him the greatest amount of *actual* satisfaction which is within his reach...It gives him the chance of not surfeiting himself with bus rides, or stinting himself unduly of the countenance of Charlie Chaplin...It enables a man as producer to concentrate his attention on his own job and so to add more effectively to the general flow of goods and services which constitute the real income of society. The existence of money...seems so be a necessary condition for any great development of the division of labour."—*Money*, pp. 5-8.

manufacturer, must be based upon a comparison of the merits and demerits of a series of actions that could be taken. By making this task simpler, money affords the consumer a better chance to make purchases that will represent his best judgment of the alternatives offered. Lastly, the time options permitted by the use of money are of great advantage to the consumer. Without some liquid object (such as money) he would be forced to accept his income in the form of commodities which, being perishable, may lose their value before they could be consumed. Thus, receiving payment in money, he is able to postpone his purchases until the most advantageous time from his point of view, thereby increasing the satisfaction which he receives. Time option also permits the consumer to protect himself against certain kinds of emergencies. With his money, he can hold a reserve of purchasing power so that, if he finds his future needs to be different from his present needs, he can shift his buying from one set of objects to another without difficulty or inconvenience.

It should not be imagined, however, that barter is totally extinct nowadays. It still goes on in some cases even in the most advanced commercial countries but only when its inconveniences are not experienced. Domestic servants receive part of their wages in board and lodging ; the farm labourers may partially receive payment in kind or the use of a piece of land. In a large majority of transactions, money intervenes in one way or the other and, even when it does not pass from hand to hand, it serves as the measure by which the amounts given and received are estimated.

Evils of Money Economy. Nevertheless, there are various dangers associated with the use of money. It makes it easy to lend and borrow things which sometimes proves detrimental to the best interests of the society. The value of money, moreover, as we shall see presently (Chapter VI), does not always remain stable. Its power to purchase goods and services changes from time to time thereby prejudicing one section of the community against the other, and if these fluctuations are rather wide, crippling trade and industry altogether. It produces inequalities in the distribution of income and thus leads to the concentration of wealth into the hands of capitalistic classes. It is responsible for the modern system of wages which is highly injurious to the labouring classes. "Money is regarded as the cause of theft and murder, of deception and betrayal. Money is blamed when the prostitute sells her body and when the bribed judge perverts the law. It is money against which the moralist declaims when he wishes to oppose excessive materialism. Significantly enough, avarice is called the love of money ; and all evil is attributed to it."[1]

It is true that some of these evils are inherent in the use of money and must be tolerated as the price which the society must pay for the multifarious advantages which it derives from its use. Many

1 Ludwig von Mises—*The Theory of Money and Credit*, p. 93.

defects of money economy will also be found to exist even in barter economy and many could easily be overcome by social reforms. In any case, a "well managed" system of money is any day better than a system in which there is no common medium of exchange such as the one visualized by some of the ardent supporters of socialism.

SUMMARY

Definition of Barter. Exchange of commodities for commodities or services is called Barter.

Defects of Barter. *(i)* Lack of double coincidence of wants. *(ii)* Want of a measure of value. *(iii)* Want of means of sub-division.

Meaning of Money. Money is nothing but an intermediate commodity designed to remove the defects of barter, or simply, a purchasing power—something which buys things, and is universally acceptable. Modern money consists of coins, notes and bank balances withdrawable by means of cheques.

Characteristics of Modern Money. *(a)* Its value in itself bears no relation to what it will buy ;

(b) it has purchasing power either because it is "legal tender" or payable into something which is legal tender ;

(c) since its supply can be varied at will, it has got to be "managed". The objects of "management" are :—

(i) to adjust the supply to the requirements of business ;

(ii) to maintain an even flow ;

(iii) to maintain stability of value ; and

(iv) to inspire confidence.

Functions of Money. "Money's a matter of functions four : A medium, a measure, a standard and a store."

It is possible to use different substances for performing each of these four functions but it is convenient to select a single substance to perform all the functions of money.

Characteristics of Good Money. Many articles were tried as money but most of them were abandoned because they did not possess many of the following essential qualities :—

(i) Utility and value. *(ii)* Beauty. *(iii)* Universal desirability. *(iv)* Durability. *(v)* Homogeneity. *(vi)* Divisibility. *(vii)* Malleability. *(viii)* Stability of value.

The only two metals that possess these qualifications in a more or less degree are gold and silver and they constitute universal money independently of all conventions and law.

Advantages of Money Economy. It is ideally suited to the modern economic organization based on large-scale production and division of labour. It helps the sale and purchase of goods and services and measures amounts given and received. The consumers gain not only because they get cheaper articles of a larger variety, but also because they can lay out their expenditure to their best advantage.

Evils of Money Economy. It makes it easier to borrow and lend money with all their evil effects. The value of money does not always remain stable and thus, at times, proves harmful to people, trade and industry.

QUESTIONS

1. Explain the conditions in which barter is possible. Why does sale for money take the place of barter ? (U. P. Board Inter. 1926 and Delhi Inter. 1929).

2. Define money. What functions are performed by money at the present time ? (U. P. Board Inter. 1933 and Delhi Inter. 1930).

3. What are the characteristics of good money ? (Delhi Inter. 1928).

4. Write short notes on :—

(a) Inconveniences of Barter. (Agra B. A. 1934 and 1935).

(b) Barter Economy and Money Economy (U. P. Inter. 1934).

CHAPTER II

FORMS OF MONEY[1]

Money is generally classified as (1) Metallic Money, and (2) Paper Money.[2]

Metallic Money. It consists of coins of metals like gold, silver, copper and aluminium and their alloys, etc., appropriately stamped so as to make known their denomination and value.

Coinage—Free, Limited and Gratuitous Coinage. When gold and silver were first used as money they were lumps or bars of metal shaped into rings, discs and roughly cut pieces. No attempt was made to so fashion the metal that its weight could not be altered without destroying the shape and design. All payments had to be made by weight and the metal had to be frequently assayed or tested to see that it was of the required purity. In order to secure uniformity in coins of the same kind, convenience of shape, size and weight, and to prevent counterfeiting, the modern coins are properly stamped on either side and their edges milled to prevent clipping. This process of manufacturing metallic money is called coinage.[3] Thus the guiding specifications of a good coinage system are : (1) that the coins be of convenient size; (1) that they be alloyed in such a way as to resist the wear of circulation ; (3) that they be designed to prevent counterfeiting and clipping ; and (4) that they bear an appropriate and artistic official stamp. Coinage is said to be *free* if the public is allowed to offer bullion for being converted into coins ; it is called *limited* when coinage is done on Government account only. The coinage of England, until recently, was free while the coinage in India, ever since 1893, has been limited. In the U.S.A. coinage of gold is free and unlimited. People are permitted to take to the mint any amount of gold bullion in excess of $100 and either have it coined or receive any other kind of money for it. On the other hand, the coinage of silver subisidiary coins is limited. Individuals are not

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1 For an advanced study of the subject read Keynes—*A Treatise on Money,* Chapter II.

2 Von Mises has suggested another method of classification. "We may give the name of *commodity money* to that sort of money that is at the same time a commercial commodity ; and that of *flat* money to money that comprises things with a special legal qualification. A third category may be called *credit money,* this being that sort of money which constitutes a claim against any physical or legal person."—*op. cit.,* pp. 61-62.

3 Jevons has defined coins as "Ingots of which the weight and fineness are certified by the integrity of design impressed upon the surface of the metal."—*Money and the Mechanism of Exchange,* p. 57.

free to take silver bullion to the mint. When there is need for additional subsidiary coins the Government buys the required metal in the market at the market price. In a system of free coinage, if no fee is charged by the Government for the work of minting, the coinage is called *gratuitous*. It will exist where it is intended that the coin should be identical in value with an equal quantity of gold bullion so that it shall be so much certified bullion and shall be reconvertible into ingots without loss.

Brassage, Seigniorage and Debasement. If the Government takes out of the coin an amount of metal equal to the cost of coinage, this deduction is called *brassage*. If a fee larger than the cost of coinage is charged, the difference between the amount thus taken out and the cost of minting is called *seigniorage*. Brassage refers to the charge made by the mint to cover such items of cost as assaying the bullion, alloy, etc. Seigniorage means an extra charge for revenue or for profit made by the state in view of its internal monopoly of manufacturing coins. When a coin contains less than the standard amount of precious metals the difference between standard and real value is called *debasement*.

The disadvantage of gratuitous coinage is that coins minted on one day may be melted down the next or long before they are worn out. Some people may find it less troublesome, at times even more profitable, (as during the Great War I in India) to melt coins than to purchase bullion if the coin contains just about as much bullion as it will buy. On the other hand, if a country on a gold standard charges seigniorage for coining, then its coins are not perfectly interconvertible with gold bullion and public confidence is rudely shaken. If coinage is not gratuitous, the bullion value of a coin is of course less than its face value and the melting of coins is consequently discouraged. This is why the Indian Rupee, which was open to free mintage in the beginning, ceased to be so after 1893.

Natural and Token Coins. Some coins are natural or full-bodied, that is, the value printed on them (or their face value) is equal to the value of the metal contained in them (or their intrinsic[1] value). The coins whose face value is higher by law than their intrinsic value are called token coins. Token coins are ordinarily of smaller denomination than the monetary unit and their purpose is to facilitate payments of small amounts. They are usually made of silver and other baser metals such as copper, nickel, or bronze. Such coins may circulate freely at their face value in the country of origin but would not be accepted in other countries except at their metallic value. Hence their use is restricted to payments arising out of internal transactions only.

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1 Jevons discards the word "intrinsic" as being ambiguous in favour of "metallic" value to distinguish it from the "nominal", "customary", or "legal" value, at which a coin actually does, or is by law required to, exchange for other coins.—*op. cit.*, p. 75.

Standard Coins. Natural coins, on the other hand, serve as standard coins. They constitute, wherever they exist, the principal or ultimate means of payment both within the country and outside, and the value of the token coins is fixed with reference to them. Although a standard coin is one of which the value-in-exchange depends solely upon the metal contained in it, it is not necessary that it should always be a full-bodied coin. A token coin may sometimes act as a standard coin ; for example, the Indian Rupee is a token coin and yet the values of all other kinds of money are adjusted to it. It has, therefore, been called a *standard-token coin.* It is useless for external payments because it may not be exported to countries where it is not legally current.

Legal Tender—Limited and Unlimited. Natural coins are easily accepted by the people because of their value as metal but token coins are not accepted quite as readily unless they are made legal tender by the Government. Legal means 'by law' and tender means 'to give'. Any currency (metallic or paper) which a debtor may give in settlement of dues owing to him or any kind of money which, according to law, must be accepted when offered in payment of obligations expressed in terms of the country's monetary unit is called *legal tender.* Token coins, which are generally intended for transactions of smaller value, are legal tender up to a certain extent only, as shillings in England are legal tender up to 40 shillings or the Indian 4-anna, or 2-anna, or 1-anna pieces which are legal tender up to Rs. 10. A standard coin, even in those exceptional cases when its intrinsic value falls far short of its face value (as in India), is always an unlimited legal tender. Similarly, the notes of the Reserve Bank of India are unlimited legal tender all over India.

It must be clearly understood that the legal tender law has nothing to do with contracts or other obligations not payable in money. Neither does it apply to contracts which, by their terms, are payable in any particular kind of money.[1]

Paper Money—Its uses. In order to save precious metals from wear and tear and to preserve them for purposes of art, paper money has been invented. It is *easier to handle* and *safer, cheaper,* and

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1 It will perhaps not be out of place here to make distinction between "the unit of currency" and "the unit of account". The former is legal tender while the latter is not. "The monetary unit for purposes of calculation is called "the unit of account." Normally the unit of currency and the unit of account are the same, for clearly the use of money as a measure of value springs from its use as a medium of exchange. It is possible, however, for the two units to be different, provided that an exchange ratio between them can be somehow established. Thus in Germany in 1923, when prices were rising very rapidly, contracts were often made in terms of Swiss francs or United States dollars. When the time for payment arrived the payment was made in marks, the number of marks given being the number required to equal the specified sum of francs or dollar at the rate ruling at the time in the foreign exchange market. The mark remained the unit of currency but the unit of account was the franc or the dollar." Benham—*Economics* p. 340.

more *convenient* for making payments in distant places than metallic money. It also helps the Government, when its credit is low, to raise necessary funds with less cost than it would have to pay if it resorted to borrowing.[1]

Kinds of Paper Money. There are three kinds of paper money :—

1. *Representative Paper Money.* It derives its value not from the paper on which it is printed but from the standard coins for which it can be exchanged. It represents an equivalent amount of metallic money deposited in the strong-room of a bank or of a national Treasury. The American gold and silver certificates guaranteed by gold and silver deposits in the Treasury of the United States or the Gold Bullion Certificates recommended by the Royal Commission on Indian Currency and Finance for India in 1927 are good examples of this kind of paper money.

2. *Fiduciary Paper Money.* This consists of notes for which specie can be had on demand. As all the note-holders are not likely to present notes for conversion at the same time, the amount of metal kept in the reserves is much less than the face value of the notes issued—the rest being backed by securities. The security portion of the reserve is called the *fiduciary* or *the invested portion.* Fiduciary paper money is not intended primarily to serve as a substitute for coin as is true of the representative type. Its purpose is rather to supplement the metallic money and to expand the total volume of the currency. To the extent that the fiduciary paper money is not backed by a reserve of 100 per cent it is equivalent to a loan to the Government without interest.[2]

3. *Fiat Money.* It represents nothing and confers a claim to nothing. It is pressed into service when the Government is hard pressed for money. The most important instances of such money are the Greenbacks issued by the American Government during the Civil War, the French Assignats issued by the Revolutionary Government of France in 1789 and the Bank of England notes issued during the Napoleonic Wars. In the Great War of 1914-19, all the European countries made their notes inconvertible. In order to bolster up its value fiat money is, as a rule, made legal tender for all public and private debts. Since it amounts to direct taxation of the people without their consent, this kind of money is generally unpopular and frequently circulates at a considerable discount. The Rs. 2½ and Re. 1 notes, which were issued by the Government of India during the last war, belonged to this category.

Evils of Paper Money. The paper money suffers from various defects. Its value is *precarious* because it is dependent on the will of the legislator or upon the solvency of the issuing bank. Should

1 Also see Inflation and its Effects at the end of Chapter VI.

2 See also Keynes—*A Tract on Monetary Reforms.*

the law demonetize paper money or repudiate it, the holder will have in his possession nothing but bits of paper because when paper has lost its legal recognition it has lost all. Secondly, its value is more *restricted*, that is to say, its circulation is limited to a *narrow area* than metallic money. As a note derives its value from the law of a particular nation it cannot be expected to circulate beyond the boundaries of that nation. Thirdly, its value is more *changeable* than that of metallic money for the simple reason that the quantity of paper money mostly depends on the will of the Government of the issuing bank.

The difference between the amount of notes issued and that of the metallic reserve is invested in securities so as to earn interest but the use of paper money in excess of the specie reserve means to the Government or the bank so much purchasing power created out of nothing. This process, when taken to its logical conclusion, leads to inflation with its attendant evils, *viz.*, rise of prices and loss of purchasing power. It strikes hardest the poor and the ignorant and thus makes the burden of taxation very heavy. It encourages speculation of the worst type. The business community is demoralized. Security, steadiness and sound business give place to gambling and the desire to get-rich-quick spells disaster for a good many. The excessive issue of fiat money puts a premium on gold and that leads to the flight of metallic money and a sharp decline in the rate of exchange. Not infrequently we have the curious spectacle of duplicity of prices. Each commodity has two prices—one payable in metallic money and the other in paper, the difference between them depending on the depreciation in the value of paper money. That is why some economists have gone so far as to say that the paper money is the "greatest plague of nations and that it is more injurious to society than a terrible disease is to an individual." It must be noted, however, that the evil effects are due rather to the imprudence of governments and banks than to the nature of paper money itself.

SUMMARY

Forms of Money. Money is classified as *(a)* Metallic and *(b)* Paper Money.

Metallic Money is made up of coins of different metals properly shaped and stamped to prevent counterfeiting. Coins are manufactured (or coined) by the government. If the public is allowed to offer bullion for being converted into coin the coinage is said to be *free*, otherwise *limited*. The coinage of India was free before 1893 and has been limited since. If no fee is charged for minting, the coinage is called *gratuitous* but if a fee equal to the cost of minting is charged it is called *brassage*. If a fee larger than the cost of coinage is charged, the difference between the amount thus taken out and the cost of minting is called *seigniorage*. The difference between the standard and actual (real) amount of metal contained in a coin is called *debasement*. A *natural* coin is one whose face value (*i.e.*, value printed on it) is equal to its intrinsic value (*i.e.*, value of the metal contained in it) ; a *token* coin is one whose face value is higher by law than the value of its metallic contents. Natural or full-bodied coins are used as standard coins, that is, for measuring the values of all other coins, goods, and services ; while token coins are

1 See end of Chapter VI.

used for payment involving fractional payments. When a token coin acts also as standard coin (as in India) it is called *Standard Token Coin.* Natural coins are unhesitatingly accepted because of their intrinsic value but token coins circulate by the force of law behind them. Coins (and paper notes) which people are required by law to accept up to any amount are called *unlimited legal tender (e.g.,* Sovereigns); coins (and paper notes) which people may accept up to a certain amount only are called *limited legal tender* (shillings in England and small coins in India). A standard token coin is generally unlimited legal tender (*e.g.*, the Indian Rupee).

Paper Money. It saves precious metal (which it displaces) from wear and tear and is easier to handle, safer, cheaper and more convenient, especially for making big payments and in distant places. It enables governments in difficult times to get more money without much cost. There are three kinds of paper money *(a) Representative Paper Money,* which is fully backed by gold and/or silver coins and bullion and is thus the safest ; *(b) Fiduciary Paper Money,* which is backed partly by metal and partly by securities but which can be got converted into metal at the will of the holder ; and *(c) Fiat Money,* which is not covered by metal and does not carry any obligation on the part of the issuing authority to convert into anything. This is the worst and would not be tolerated by the public except under abnormal circumstances.

Evils of Paper Money.

1. Its value is precarious ;
2. Its circulation is restricted to a narrower area ; and
3. Its value is changeable. When over-issued, it leads to inflation and rise of prices.

QUESTIONS

1. Classify the various forms of money in circulation in the country and ndicate the characteristics of each. (Punjab B. A. 1932).

2. Explain the following terms :—

Token money, free coinage, gratuitous coinage, seigniorage, standard coins and legal tender. (Delhi Inter. 1933).

3. Can token money be legal tender ? What constitutes legal tender in India ? (U. P. Board Inter. 1929).

4. How does the rupee, though unlimited legal tender, fail to satisfy all the conditions of standard money ? (Delhi Inter. 1920).

5. The rupee may be called a 'standard token' coin. Explain. (Delhi Inter. 1929).

6. What are the characteristics of paper money ? Why is it preferred to metallic money ?

CHAPTER II

FORMS OF MONEY—*(Continued)*

SOME PROBLEMS OF PAPER MONEY

Elasticity of Paper Currency. In order to guard against the evils resulting from over-issue (and sometimes under-issue) of notes, it is necessary to make their amount conform to the requirements of trade. Their circulation should increase in the busy season and decrease in the slack season. This is not always possible. No one can import or export notes like coins and no one but the government or bank authorised by the government can issue or cancel them. Hence, if trade becomes brisk, nothing but a decree of the government can supply the requisite increase of circulating medium and if more money is put into circulation and trade relapses into dullness the currency becomes superfluous and falls in value. This power of notes to adjust their volume to the need for currency is called *elasticity*. Dunbar has defined elasticity "as responsiveness to present increase or diminution of demand—the power of adaptation to the needs of the month, the week, or the day whether rising or falling."[1] The elasticity of currency is of special interest to India where the demand for currency varies from season to season and where cheque currency is less popular than elsewhere.

Mobility of Paper Currency. Just as the volume of currency should be altered to suit the varying requirements of trade, it should also be capable of being transferred from centres where it is not needed to those where it is urgently required. The capacity of note-issue being moved from place to place may be called *mobility*.

Government *versus* **Bank Note-issue.** It is an open secret that even the best informed government departments cannot be trusted to judge wisely and impartially when and where more money is wanted or when or from where superfluous currency ought to be pumped out. It is usually out of *direct* touch with trade and industry and is "not as sensitive as a bank to the conditions in the financial and commercial world."[2] The government's difficulty may be greater in an emergency when business men have very urgent need of cash because the government mechanism is a slow but cautious process and is not readily responsive to sudden changes. A government whose primary duty is to look to the security of the currency system is naturally forced to study the problem that arises patiently and

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1 *Economic Essays*, p. 238.

2 Kisch and Elkin—*The Central Bank*, p. 73.

thoroughly with the result that some time elapses before any action is taken and the emergency demand may go unsatisfied. It may, therefore, happen that at times the supply of currency is less than its demand, *viz.*, there is stringency of money, or that the supply exceeds the demand *viz.*, there is over-issue of money."[1] Moreover, if the power of issuing notes is entrusted to the government, there is a danger of the true economic interests being sacrificed for the sake of political considerations and financial needs of the State. A party in power may issue huge quantities of notes just to serve its own ends and may even *create*[2] securities to satisfy its own legal conscience. The bank note-issue is free from these defects. A bank is constantly in touch with producers and business men and is thus in a better position to appreciate the needs of the market from time to time. It has a control over credit money (like bills of exchange, etc.[3]) which it can profitably utilize to accomplish what metallic and paper money alone would fail to achieve, namely, adjusting the volume of currency to *temporary* and *seasonal* requirements of trade and commerce. It is not concerned with party politics nor is its policy deflected by deficit budgets or military expeditions, etc. The amount of note-issue is regulated by specific laws which definitely specify the proportions of gold and securities to be put in reserves. Any departure would at once be set right by the force of public opinion and Government authority.

Single *versus* **Multiple Note-issue.** Having decided that the note-issue should be entrusted to a bank (rather than to the Government) it remains to be seen whether it would be expedient to extend this privilege only to one bank or to all (or many) banks of the country. In the interest of controlling currency and credit effectively, centralization is clearly the best. It ensures a proper degree of *uniformity*, *elasticity* and *mobility* unhindered by conflicting policies that may be pursued by different institutions. It also means centralized reserves which are more economical and easier to mobilize especially in times of grave national emergencies. Ordinary commercial banks are chiefly guided by profiteering considerations and the tendency among them to compete for increasing their gains from this source may result in reducing the metallic portion to the minimum and in swelling the volume of currency beyond legitimate trade requirements. This difficulty would not arise if note-issue is contolled by a single bank. "The very independence of a bank with monopoly privileges removes from it all temptation such as might be presented in competition with rivals, to extend its issue beyond the limit of safety. As the struggle to earn dividends is absent the bank may order its polity to secure public

1 Dadachanji—*A Reserve Bank for India and the Money Market*, p. 18.

2 Such securities are called "created" or "ad hoc" securities which (in India) are nothing but treasury bills issued by Government to itself. Until lately, the currency notes in India were issued by Government against its own I.O.U's. See Kale—*Indian Economics*, pp. 529-30.

3 See Chapter IV.

welfare."[1] It is possible to assign responsibility and to check faults. "It puts an unmistakable duty upon those in whose hands the course of monetary affairs rests and makes impossible the negligence and irresponsible venturesomeness observable with a multitude of competing banks."[2] It also ensures effective State *supervision*. Moreover, the concentration of note-issue in one bank which also enjoys the support of the State gives such notes a distinctive *prestige* not attaching to notes issued by several banks—a prestige which has proved to be of great value in a crisis or other emergency. Hence note-issue must invariably be controlled by one bank, preferably the Central Bank of the country, because then the Central Bank will have an opportunity of exercising such influence over credit expansion by commercial banks as it considers to be appropriate under the prevailing conditions.

Case of India. It will be interesting in this connection to remember that the Indian paper currency system has passed through all these phases. Notes were first issued by the three Presidency Banks but came to be issued by the Government in 1861. The defect of the system soon became apparent and an half-hearted attempt was made to transfer control to one bank when the Imperial Bank was empowered to issue notes up to Rs. 12 crores in the busy season on the security of inland bills of exchange in 1924. A real step in the right direction has been taken now that the newly constituted Reserve Bank has been made wholly responsible for the management and control of paper currency in India.[3]

System of Note-issue. While the economists admit the necessity of elasticity as a necessary feature of a good system of note-issue, they are not agreed as to the *degree* of elasticity that any system should possess and the *extent* to which the limit of safety may be transgressed. An attempt has, therefore, been made to give a general idea of the systems prevailing in different countries which will also incidentally illustrate the difference of opinion concerning the principle of note-issue.

Existing Methods of Note-issue :

1. *Fixed Maximum of Note-issue*—as prevailed in France between 1870 and 1928[4] and in England and Japan since 1939 and 1941, respectively. According to this system there is no fixed relationship between the note circulation and the amount of metallic reserves. The law prescribes a maximum limit of note-issue which cannot be exceeded, no matter what the amount of reserves may be. The maximum is generally in excess of what the note circulation is expected to be in normal circumstances and is liable to be revised upwards from time to time. This system is *inelastic* because in fixing the maximum it pays no regard to the relation that must exist

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1 Jones—*Economic Crises*, p. 111.
2 *Op. cit.*, p. 111.
3 Also read Chapter XIII.
4 The legal maximum fixed was 59,431 million francs.

between the note-issue and trade requirements. It "provides no guarantee against inflation owing to the possibility of raising the limit by Parliamentary action whether such action is warranted or not." It has the advantage of allowing unlimited discretion to the Central Bank of using the reserves in times of need while preventing any tendency towards inflation. "If the volume of the note-issue is to be regulated by law this is perhaps the best system."[1]

2. *Fixed Fiduciary Issue* (or the *Currency Principle*) This system was inaugurated by the English Bank Charter Act of 1844 and still prevails in Great Britain, Norway and Japan.

In the case of England, the Bank of England is authorized to issue notes[2] through the Issue Department which is quite distinct from the Banking Department. Before 1928 the Bank was allowed to issue notes up to a total of £19,750,000 without putting any gold or silver in the reserve. This was the Bank's maximum fiduciary issue and all notes issued in excess of this sum had to be fully backed by gold. By the Currency and Bank Notes Act of 1928 the Bank has been authorized to issue notes against the Issue Department's total holdings of gold coin and bullion and, in addition, to issue notes against securities to an amount of £260,000,000. The fiduciary limit cannot be increased except by the sanction of the Treasury and may not continue for a period of more than two years without the ratification of Parliament. The original fixed fiduciary principle continues with the only difference that the limit of the fiduciary portion has been gradually raised from £14 million in 1844 to £260 million as at present.[3] That the system has become fairly

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1 Keynes—*A Treatise on Money*, Vol. II. p. 266.

2 In addition to the notes of Bank of England, notes are issued by certain Scottish and Northern Irish Banks but the latter are not legal tender in England and Wales.

3 There have been violent changes recently. The limit was raised to £275 millions on August 1, 1931 and lowered to £260 millions on March 31, 1933. On December 15, 1936, the limit was lowered to £200 millions, in November 1937 it was raised to £220 millions for a period of two months and in January, 1938 when the note-circulation declined, it was again reduced to £220 millions. In December 1938, it was increased to £230 millions for the same reasons as in the preceding year and early in January 1939 it was further increased to £400 million in order to facilitate the transfer of £200 millions gold from the Bank of England to the Exchange Equalization Account. In the following month, however, it was reduced to £300 millions as a result of revaluation of the remainder of the Bank's gold holdings at current market price. It was then raised to £580 millions in September 1939 when all the gold held in the Issue Department of the Bank, and valued at about £280 millions at the market price, was transferred to the Exchange Account with the object of concentrating the country's resources in one reserve ; and finally in order to provide for the continuous expansion of the note-issue under war conditions, it was increased to £630 millions in June 1940, to £950 millions by December 1942 and to £1400 millions by December 1945.

Thus, the position since September 1939 has been that England has abandoned the system of a partial fiduciary issue, and that the note issue of the Bank of England is now directly covered only by Government securities and a trifling amount of gold and silver coin.

elastic since 1928 can be proved by the fact that in September 1931, when the Bank's gold stocks were completely exhausted on account of heavy withdrawals by the Continental countries, the fiduciary issue was increased from £260 millions to £275 millions.

In Japan the Bank of Japan is allowed to issue notes to an amount not exceeding Yen[1] 120,000,000[2] on the security of Government debt, other reliable securities or commercial bills. Any issue over and above this limit is to be secured by 100 per cent gold and silver unless the limit is itself raised which was done in 1932, 1938 and 1939. In its essentials, therefore, it resembles the English system.

Other countries which tried this system were Norway, Finland and Italy prior to 1926.

This system requires that almost *all* the notes should be backed by an *equivalent amount* of gold (and/or silver) in the reserves. It restricts the fiduciary portion to a nominal figure with an additional *proviso* that the net circulation of notes will be reduced as soon as a portion of the metallic reserve is lost by the exportation of gold to foreign countries. On the eve of Great War I the Government of India was legally authorized to issue notes worth 20 crores of rupees only against securities and had to find bullion or coin for the rest. This system obviously makes the note-issue as *safe* as *gold bullion certificates* which are free from the artificial manipulation of currency. It thus serves a useful purpose as a brake on undue expansion of currency and credit in times of prosperity. It would work particularly well if the fiduciary issue is fixed high enough to leave the Central Bank in unfettered control of the bulk of its gold reserves. It is, however, regarded as *uneconomical* because it makes the expansion of paper currency dependent not upon the prosperity of trade but upon the increase in the output of gold and silver mines. It renders the issue of currency very *rigid* and *inelastic*. An internal or external drain of gold is bound to cause an undue contraction of currency and credit and is, therefore, not sufficiently adaptable to heavy demand for currency in financial panics and other emergencies. It also necessitates locking up of enormous quantities of gold which could otherwise be used for productive purposes. It is unsuited to countries where gold coins do not circulate.

3. *The Percentage System (or the Banking Principle)* which has been characterized by Keynes as "the most fashionable system at the present time" exists, among other countries, in the United States, France, Germany and India. It does not require the note-issuing and banking functions to be separated into two different departments. It prescribes that the gold reserves shall not fall below a fixed percentage (30 to 40 per cent) of the note issue. The minimum is not rigidly fixed but may be lowered with the consent of the government

1 Yen = Rs. 1-6-0.

2 This limit was raised to 1,000 million yens on July 1, 1932.

for short periods on the condition that the issuing bank pays a tax calculated on the amount of the deficiency. In the case of America the legal minimum of gold and gold securities is 40 per cent and the rest of the 60 per cent consists of commercial paper (bills of exchange etc.) which the Federal Reserve Bank is allowed to deal in. In Germany[1] also the Reichsbank is compelled to keep gold, covering at least 40 per cent of the total circulation, subject to reduction on payment of a tax, the object being to discourage the Central Bank from following a policy of undue expansion by imposing a tax on the uncovered excess. In other words, by taking away the profit incentive it helps to ensure that currency expansion beyond the legally covered limit would take place only in emergencies or at the seasonal peaks of trade. The remaining cover has to consist of bills of exchange or other authorized securities. In the case of Australia, Argentina, Canada, New Zealand, Czechoslovakia and Yugoslavia, on the other hand, the reserve requirement is only 25 per cent.[2] Before April 1935, the Government of India could issue notes against 50 per cent gold (and silver) and 50 per cent securities so that whenever more notes had to be issued it had to find much less gold than before the War (when India had the Fixed Fiduciary System). The present system is even more liberal.[3]

This method permits the issuing authority to issue notes in any amount to meet the demand of trade provided that there is *sufficient* gold in the reserves to convert notes on demand. The note-issue under this system is more *elastic* but this elasticity is secured at the expense of deliberate or unconscious *inflation* of currency with a corresponding rise of prices. It is *extravagant* in locking up gold for it does not exempt the irreducible minimum of note-issue permitted by the Fixed Fiduciary System. It also creates serious *tightness* of currency in the event of gold leaving the country in large amounts.

4. This is a varient of the 3rd. According to it, all or some part of the percentage reserve required against the note-issue may be held, not in actual gold, but in bills or cash at some foreign bank. The method is usually adopted by countries which have restored the

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1 This country, however, suspended the legal reserve requirement of its Central Bank in September 1932.

2 Another, and a slightly different method, has been prevalent in Holland and the Union of South Africa since 1930. It prescribes merely a minimum percentage gold reserve against notes and deposits and makes the notes a first charge on all the assets of the Central Bank. Thus, by discarding the principle of specifying the particular kinds of assets which may be used as cover for that part of the note issue not covered by gold, the Central Bank is given greater freedom of action.

3 The Issue Department of the Reserve Bank of India must hold 40 per cent of its assets in gold coin, gold bullion (gold must not be less than 400 million rupees and at least 85 per cent must be held at home) and sterling securities and the remainder of its assets may consist of rupee coin, securities, eligible bills of exchange and promissory notes. (For legal reserve requirements of other countries of the world read the League of Nations' *Monetary Review* for 1937-38, pp. 87-89.)

gold standard with the assistance of the League of Nations and is in accordance with the recommendations of the Genoa Conference of 1922. It has the great advantage of economising gold but is open to the same objections as the "percentage" method. The economy of gold is, moreover, optional and there is a danger that considerations of fashion and prestige may lead some countries to hold actual gold.

The Right Principle of Note-issue. The system which a country should adopt would depend mostly upon the supply of gold, the habits of the people, and the conditions of the money market, etc., but, as a matter of principle, every civilized country should have only one form of note and that issued by the Central Bank. The Bank should be quite free to manage its own reserves and those of the member banks but the law may usefully limit its discretion in two ways, namely, (*a*) it may require that the gold reserves shall not fall below a stated minimum figure, and that (*b*) the note-issue shall not exceed a fixed maximum. This would create a psychological confidence and prove a delaying safeguard in emergencies. Such a system exists in Italy and Spain. In the case of Spain, the reserve requirement is peculiar. The percentage is made to increase with increase in issue up to the maximum limit. It is unduly safe and hence inelastic and does not serve as a good model for more enterprising countries.

It must, however, be borne in mind that in recent years and under the stress of circumstances, several countries indefinitely suspended or abolished reserve requirements without laying down any maximum for the note-issues of their central banks, namely, Germany, Italy, Greece, Peru and Bolivia during the thirties; France, Canada, Denmark and Belgium during the War; and Australia in 1945. In Australia, according to the explanatory memorandum on the new Commonwealth Bank Bill, the absence of any restrictions or limits on the note-issue was justified on the ground that in modern banking policy more emphasis needs to be placed on the control over that part of the credit base which consists of trading bank deposits with the central bank, rather than over the note-issue which is only a *reflection* of note policy. The point is, however, that Australia never required the maintenance of a minimum reserve against the deposits of the Central Bank and that, with the abolition of the reserve against notes, there is now no legal limit to either the note-issue or the credit base.[1]

SUMMARY

Elasticity of Paper Currency. Paper money must be elastic, that is, its supply must be capable of being increased or decreased in accordance with the requirements of trade. Elasticity is particularly necessary in the case of agricultural countries like India where the demand for currency varies from season to season and where cheque currency is comparatively less popular.

Mobility of Paper Currency. Refers to the ability of paper currency to be moved from places where it is abundant to places where it is scarce.

1. M. H. DeKock.—*Central Banking*, pp. 37-38.

Government *versus* Bank Note-Issue. The government departments do not keep in direct touch with trade and industry nor are they sensitive to conditions in the financial and commercial world. They study every problem patiently and minutely and are, therefore, unable to make quick decisions in emergencies. There is also the danger of political considerations and financial needs of the State determining the volume of currency in circulation. The bank note-issue is consequently more desirable.

Single *versus* Multiple Note-Issue. Should one or all banks be allowed to issue notes ? One bank can co-ordinate credit and currency more effectively and can ensure greater degree of elasticity and mobility than many banks following conflicting policies. A single bank has less temptation to make profits out of note-issue and can at once be pulled up as soon as that desire becomes apparent.

Systems of Note-Issue. In order to secure elasticity and yet provide sufficient safeguards against undue expansion (and contraction) of currency, the note-issue should be entrusted to the Central Bank which generally bases its issue on any of the four well-recognised principles, *viz*.: (1) Fixed Maximum of Note-issue, which puts a maximum limit (which may be gradually increased) to note-issue which cannot be exceeded in spite of the size of the reserves. It does not regulate note-issue in accordance with the needs of trade but puts unlimited powers in the hands of the Central Bank to expand currency without the fear of inflation. (2) Fixed Fiduciary Issue, (prevalent in England, Japan and Norway). It provides that barring a small amount of notes which may be backed by securities, the rest must be fully covered by metal in the reserves. It is safe but uneconomical and makes note-issue comparatively inelastic and unresponsive to the requirements of trade. (3) Percentage or Proportional Reserve System, (exists in U.S.A., Germany, India, etc.). It allows a certain fixed percentage (30 to 40 per cent) to be covered by metal and the rest by securities. This secures greater elasticity but only at the expense of deliberate or unconscious inflation of currency. It may also lock up too much gold in the reserves and, on the other extreme, bring about a drastic reduction of note-issue in the event of gold being exported out of the country. (4) This system is a variant of the third. It permits reserves to be maintained not in gold but in bills and cash in foreign banks. It economises the use of precious metals but is exposed to the same defects as (3). In actual practice, however, a large number of countries, out of considerations of fashion and prestige, prefer to hold actual gold.

The Right Principle of Note-issue. The system of each country would depend upon its own economic conditions but if the law fixes a minimum absolute figure for the gold reserve and a maximum absolute figure for note circulation, both these limits being subject to reasonable revision from time to time and so chosen as to allow a wide discretion to the Central Bank, no more safeguards are necessary.

QUESTIONS

1. What do you mean by "elasticity" and "mobility" of paper money ?

2. Give arguments for and against the government system of note-issue. Assuming the government monopoly of note-issue being undesirable, what other alternative or alternatives would you suggest and why ?

3. Point out clearly the comparative merits of the Fixed Fiduciary Issue system and the Proportional Reserve system of note-issue in a country like India. (Delhi Inter. 1930 and Delhi B.A. 1933).

4. What do you think is the right principle of note-issue ? Illustrate your answer with reference to the systems prevailing in different countries of the world.

CHAPTER IV

CREDIT MONEY

Meaning of Credit. We have seen that the sale and purchase of commodities can be made by money. It now remains for us to see how the same object can be accomplished *without* the use of money. A man wants a hundred rupees, and, if he has nothing tangible to offer in exchange, he borrows them against a promissory note. A shopkeeper wishes to purchase goods from a producer for sale but he cannot pay for them straightaway. He, therefore, gives a a written promise to pay the price of the goods some time hence. In either case capital has been put by one man at the command of another to be repaid at some future time. Credit, therefore, may be defined as a *protracted exchange,* that is, exchange which is not complete until a certain period of time has expired. "Introduce the element of time into exchange," says Gide, "and it becomes credit......... credit may be defined as the exchange of present wealth for future wealth."[1]

Now, no man will part with his goods in exchange for a promise to pay money unless he has confidence in the ability and will[2] of the debtor to make payment when it falls due. This confidence is partly based upon the borrower's property and partly upon his personal characteristics. Every creditor will satisfy himself about the character of his client and the character of his business[3] before granting credit. Hence, the fundmental elements of credit are *time* and *confidence*[4]. Tucker has defined credit as"the transfer of something valuable to another, whether money, goods or services, in the confidence that he will be both willing and able, at a future day, to pay its equivalent.[5] The extension of credit

1 *Principles of Political Economy,* p. 356.

2 Or, in his Character, Capacity, Capital and Collateral which are popularly known as the four "C's" of credit.

3 There is a close relationship between these two factors because "a man of excellent business ability......would have his business properly organized and, on the other hand, if it were found that a business was poorly equipped and managed, it would be certain that the man's business experience or business capacity was strictly limited. An investigation of these two kinds, however, usually serves to furnish a more adequate basis for a sound judgment of the risks involved." Marshall—*Industrial Society,* p. 228.

4 The word 'credit' has been derived from a Latin word 'credo', which means 'I believe'.

5 *Theory of Money and Banks Investigated,* p. 121.

H. D. MacLeod in his *Theory of Credit* has defined it as "a right of action". This gives us the legal aspect of credit. A man who gives a promise to pay money gives a right of action against himself. The holder of the promise may sue him for payment and the law will enforce the payments.

between nations depends upon the stability of political institutions, the general economic organization of each country and upon the state of law relating to borrowing and lending, especially the readiness with which contracts can be enforced. Similar considerations apply in the case of different industries in the same country. Those which possess the greatest power to borrow are those which can show the greatest progress as measured by profits while those that have lost their credit in the market owing to defective organization or persistent losses find it very difficult to tempt investors to entrust their money to them.

Instruments of Credit. Although trust or confidence is the essence of credit, it is customary for there to be in existence some tangible evidence of the debt created. Since credit involves a promise of repayment at some future time, written evidence of the debt is usually taken by the creditor from the debtor and such forms of evidence are known as *Credit Instruments*. These include Bills of Exchange, Drafts, Promissory Notes, Book Credits and Cheques, etc. The Bills of Exchange and the Banker's Drafts are used for foreign remittances or among people living in distant corners of the same country and have, therefore, been discussed in the chapter on Foreign Exchanges. Here we will discuss the meaning and working of the other credit instruments, *viz.*, Promissory Notes, Bank Notes, Cheques and Book Credits.

Promissory Notes. A promissory note is an unconditional promise in writing to pay a certain sum of money at a stated time. It is the simplest form of credit instrument and is probably the first that came in use. It may be given by a man or woman, by a firm or corporation, in order to borrow money or in payment for goods. It will not be accepted except by men who have confidence in the maker or the witness (endorser) whose signatures are also required to complete the transaction. A promissory note, therefore, is capable of serving as a medium of exchange only within a narrow field. Its main use is not as a medium of exchange but as an instrument for the transfer of capital from lenders to borrowers.[1]

[1] The following differences between a promissory note and a bill of exchange may be noted :—

(*i*) Unlike a bill, a promissory note is not always drawn by the creditor but made by the debtor. Since the promissory note is never accepted, there is no acceptor and his place is taken by the maker whose liability is the primary one.
(*ii*) The bill is an order to pay ; a note is a promise to pay.
(*iii*) Liabilities of parties to the bill and the note vary. The drawer of the bill, when once it has been accepted, is liable only secondarily but the maker of a note is the principal debtor and corresponds with the acceptor of the bill.
(*iv*) The sections of the Negotiable Instruments Act providing for presentment for acceptance etc., which apply to bills do not apply to the note.
(*v*) A bill may be accepted conditionally but a pro-note cannot be conditional.
(*vi*) In case of dishonour of a bill, particularly a foreign bill, it must be noted and protested. A promissory note need not be protested even if foreign.
(*vii*) There is no stamp duty on bills payable on demand while all promissory notes require *ad valorem* stamps.

Bank Note. It is a bank's promise to pay money to bearer on demand. The acceptability of bank notes is due to the prevailing confidence in the stability of the banks and to the convenient denominations in which the notes are issued. "Credit is a bank's stock in trade, something which it must maintain at all costs. Its failure to redeem one of its promises on demand means immediate bankruptcy and ruin. Banks, therefore, guard their credit as a woman does her good name and as a result people come to feel that bank's promise to pay money is as good as money itself." The only difference between a promissory note and a bank note is this that the former bears interest and is private. Its full value cannot be demanded until it matures. A bank note, on the other hand, is convertible at par into legal tender money on demand. It does not bear any interest.

Bank notes are usually issued by the Central Banks. They have got to be accepted by the creditors in payment of debts. The Government does not usually require a bank to keep a specified reserve against its deposits against which cheques are drawn but a bank enjoying the right of note-issue is required to maintain a specified reserve to ensure their convertibility. Bank notes are generally regarded as cash and have a much greater currency than cheques and bills of exchange. "Bank notes pass far more frequently and far more readily than cheques and bills ; they are rarely hoarded, and are not kept out of circulation in the same way as bills of exchange which are discounted and locked away in a banker's or broker's portfolio. Consequently, the effect on prices of the circulation of bank notes is far greater than in the case of cheques and bills of exchange of corresponding amount." From the point of view of the bankers, the note system has the advantage that they do not have to bother about entering the transfers from one individual to another. To the individual the note form has the advantage that he does not have, every time he makes a payment, to produce evidence that he has a bank deposit on which to draw. On the other hand, to the banker the note form has the disadvantage that he must take greater precautions against forgery. Forgeries of book entries can be prevented by checking the honesty of clerks in the bank's employment ; but prevention of forgery of bank notes involves careful designing and choice of paper and a host of other precautions. To the individual the note form has first the disadvantage that the amount of the notes very frequently does not coincide with the amount of the debt he wishes to settle, and secondly, that the notes are as valuable to other persons as they are to himself and consequently the settlement of debts by the payment of notes involves carrying about pieces of paper which other people have the incentive to steal.

Cheques. A cheque is a written order given to a bank by a depositor requiring him to pay on demand a definite sum of money, either to a specified person or to his order, or to the bearer.[1] Thus,

The Bill of Exchange Act of 1882 defines a cheque as "A Bill of Exchange drawn on a banker, payable on demand."

the two main characteristics of the cheque are that it is an unconditional order and that it is payable on demand. If the payment on the document depends on the fulfilment of certain conditions, it cannot be regarded as a cheque. Payment on the cheque is to be made on demand, no matter whether the words 'on demand' actually occur on the cheque or not. It is a command which the banker has undertaken to honour to the extent of the amount that the drawer had previously deposited with him. The bank will obey this order if the drawer of the cheque has a sufficient sum standing to his credit at the bank to cover the amount named in the cheque or if the bank has given him the right to "over-draw" to that extent. Otherwise the cheque will be returned to the person who presented it marked R/D (Refer to Drawer) or N. S. F. (Not Sufficient Funds). The cheque, in effect, assigns to a creditor part of the funds at the debtor's disposal. Its usual effect is merely to alter figures in the banker's ledgers or books. The payee's account is increased while the drawer's account is decreased by the amount of the cheque. The cheque must contain a date which must be such as not to make the cheque stale, ante-dated or post-dated. At times, for the sake of business convenience, the date is to be filled in by the payee, as also the amount, and the practice is not objected to by the banker. Like a bank note, a cheque bears no interest and is transferable from hand to hand without any formality so that the holder is *prima facie* the owner. "If there is no doubt at all as to the credit both of the drawer and of the bank on which the cheque is drawn it is difficult to see why a cheque should be inferior to a bank note as representative money, except that it is usually drawn for an odd sum."[1] Cheques must be payable to or on the order of a certain person or to bearer. In the case of a bearer cheque, it passes from hand to hand without the endorsement of the payee or of any subsequent holder. In the case of an order cheque, however, the endorsement of the holder is required. Endorsement may be of various types. The most common form is *blank* endorsement which makes the cheque as good as a bearer cheque. It consists simply of the signature of the holder. In the case of *special* endorsement, however, the name of the endorsee must be given. In the case of *restrictive* endorsement, the further transferability of the cheque is prohibited and such a cheque cannot be treated as negotiable.

Crossed Cheques. In order to avoid payments being made to wrong persons cheques are generally 'crossed' by drawing two parallel lines on their face with the words '& Co' written in between them. The crossing assures that the cheques will in any event be paid only through a banker. The amount is simply credited to the account of the man in whose favour it has been drawn so that if there is a mistake it can be easily detected later on. Crossing may be *general* and *special*.

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1 Jevons *op. cit.*, pp. 240-41.

In the case of general crossing, only two parallel lines with or without the words "& Co" will do. In the case of special crossing, however, the name of the bank to whom crossed is mentioned within or without parallel lines. Special crossing is obviously very definite and safe. A person having no claim will find it difficult to obtain payment except through the bank mentioned therein and the bank will not collect the amount if the payee does not happen to be its customer. The transferability of a cheque is further restricted if the words "Payees' Account only" are added to it.

Cheques are generally less popular because it is impossible to be acquainted with the cheque forms of all banks, the signatures of those who draw them and the credit of the drawers. Every one accepting a cheque does so at the risk of fraud or bankruptcy on the part of the drawer. There is also the possibility of failure of the bank on which it is drawn in which case the drawee, or the man in whose favour the cheque is drawn, loses, the liability of the drawer having ceased as soon as payment by cheque has been made.

Book Credit. It is a very popular form of "business credit" now-a-days. After the buyer has completed his purchase an entry is made in the books of the seller indicating the nature of articles bought and the date and prices at which they are purchased. Charges for professional services such as those of a doctor or a lawyer fall in the same category. The money-lenders also make entries in their books. These entries are usually considered as sufficient evidence of the credit transactions and are recognized as involving the legal right of the creditors to receive payment. Book accounts are finally settled either by some other form of credit, as by cheque or draft, or by the payment of cash. This method is not only a quick and easy way of recording a sale on credit but it minimises the time of both the purchasers and sellers and obviates the necessity of carrying the large sums of money to make cash payments. In practice, however, it is attended by numerous abuses. A book entry is subject to dispute. There may not be a definite date agreed upon as to when payment is to be made although the seller may sometimes offer a discount to facilitate settlement within a short period of time. It locks up the invested or borrowed capital of the seller for an indefinite period of time and is frequently a prolific source of slow collections, bad debts and huge losses. The sellers are, therefore, compelled to quote higher prices which are passed on at continually increasing levels to the consumers.

Cash Credits ; Letters of Credit and Certificate of Deposits. *Cash credit* is a drawing account created in favour of a customer upon which he may operate in precisely the same manner as on a common drawing account. The only difference being that instead of receiving interest on the daily balance to his credit, as is very commonly the custom in Scotland, he pays interest on the daily balance at his debit. It is thus an "inverse drawing account." Persons travelling abroad take with them *letters of credit* from their

bankers entitling them to receive credit from the person mentioned in the document. A *certificate* of deposit is merely a receipt given by a banker to the depositor in exchange for money deposited by the latter.

Characteristics of Credit Money. Like all other forms of money, credit instruments also must possess at least four qualities, *viz.* : (1) They must be issued by a person in whom all people have confidence ; (2) they must be in convenient denominations ; (3) they must be easily recognizable ; and (4) they must be difficult to counterfeit.[1]

They differ from money instruments in more than one respect. They have no intrinsic value and circulate on the strength of the reputation and financial stability of a single person or institution. They pass less frequently and less rapidly from hand to hand and are seldom hoarded. Unlike money, all forms of credit do not possess the same degree of acceptability. A man's cheque or promissory note, for instance, will be taken only by people who know him and trust him whereas every one will accept a bank note. Credit may, therefore, be divided into two classes : (1) credit of general acceptability, such as bank notes ; (2) credit of limited acceptability, such as bank cheques, drafts and promissory notes. Credit of the first class is often called *money* and is even so named in some scientific treatises but we have treated it as credit.

Does the Creation of Credit Mean the Creation of Wealth ? In view of the important part played by credit in the industrial life of to-day, some people are inclined to believe that credit instruments are real wealth, true capital. They believe that credit is a factor of production and that it can create wealth quite as well as land or labour. But this is an illusion. Credit is *not* a factor of production. It is merely a *method* of production just like exchange and the division of labour. It consists in the *transfer* of wealth or capital from one person to another. *But to transfer is not to create.* Credit can no more create wealth than exchange can create commodities. As Mill has neatly put it, "credit is simply permission to use the capital of others." Suppose, for example, A lends Rs. 100 to C and gets a promissory note from him in return. The total is undoubtedly Rs. 200 (Rs. 100 in cash with the borrower and a note worth Rs. 100 with the lender). B's note, however, may be capital for A but cannot be capital *for the nation*, for A cannot negotiate the paper until some one will give him money or goods in exchange for it. The promissory note, therefore, is not capital but simply affords A an opportunity of obtaining other capital in lieu of what he has given up. Besides, A cannot support life or carry on production merely by means of pieces of paper. If credit instruments really constituted wealth, it would be quite possible to double the wealth of any community by having each citizen to lend

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1 Johnson—*Money and Currency*, p. 4.

his estate to his neighbours in exchange for a promissory note. It cannot, however, be denied that if the borrower makes a productive use of the money which the lender had allowed to remain idle, there would be some justification for calling credit capital. For money borrowed for the improvement of business and production is nothing but credit for purposes of production. Thus, credit does not increase capital in any material sense. Nor is it, in its inception,. an increase of capital. It is but a means by which capital can be given mobility and hence greater efficiency—just as horses which give to cavalrymen no increase in actual numbers, but impart to them greater mobility and increased activity.

Advantages of Credit. Although credit cannot be called productive in the strictest sense of creating capital, it renders eminent services to production by enabling us to use existing capital to the best possible advantage. Even in the case of consumption, where it has ordinarily disastrous consequences, credit renders useful service in helping us to tide over temporary difficulty and to keep simple accounts. The advantages of credit, in simple language, may be summarized thus :—

1. Credit helps production by transferring wealth from the possession of those who do not want it to those who can make a proper use of it ;
2. It furnishes us with better and more convenient methods of payment of large sums of money inside the country (*e. g.*, a cheque) as well as outside (*e. g.*, a bill of exchange).
3. It acts as a stimulant to the growth of capital. The introduction of credit institutions (*e. g.*, banks) and credit facilities (*e. g.*, lending of credit) have encouraged saving and investment of capital ; and
4. It enables us to economize the use of gold and silver as means of payment. The use of credit displaces gold in circulation and, to that extent, lowers the value of gold. This tendency can be noticed in Western countries during the period 1896 to 1913.[1]

In short, credit makes possible a more complete utilization of human and natural resources, stimulates large-scale production, and increases the efficiency of labour and capital. It has become so much a matter of habit that we seldom give thought to it. Yet it has proved to be the most vital problem in the economic activities of the world since 1914. "As a tool of exchange money is a great time-saver. Credit performs the same service and does it with infinitely greater rapidity. Money surpasses barter as the modern railroad 'flyer' surpasses the crawling canal boat, but credit leaps to its task with the swiftness of electricity. If the world were stripped of its telegraph wires, it means the communication would not suffer

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1 See Tailor—*The Credit System,* Chapter II.

more than would the business world if credit were destroyed."[1] One is, therefore, not surprised to see that in the industrial countries of modern times the use of the ordinary media of exchange is becoming less important except for small transactions. "The soundness of the monetary systems of different countries, and therefore of the world, must depend upon the soundness of the credit system—a system in which the ordinary legal tender plays the part of diminishing importance."[2]

Evils of Credit.[3] It spite of the numerous advantages conferred by credit on society its dangers should not be overlooked. When money is borrowed for purposes of consumption it is spent much more blindly than the one earned with the sweat of the brow. Similarly, when funds are raised for productive enterprises, the borrowers are tempted to spend them much more recklessly than if the money was their own. This frequently leads to over-production, over-investment and speculation which is often a cause of business destruction. The credit system disguises the financial weakness of a business community by enabling the unscrupulous people to continue in business with the help of borrowed money. The eventual failure of such people brings ruin not only to themselves but to many of those who had established commercial relations with them. If the amount of credit money is much in excess of other media of exchange, there are chances of weakening public confidence. Utmost care is generally bestowed upon the control of bank notes and yet a single untoward event may often shake public confidence and result in drastic contraction of currency. The modern credit organization is also responsible for concentrating capital in the hands of big capitalistic producers and indirectly responsible for the exploitation of labour and extermination of small-scale producers. Since credit is the life-blood of modern trade and industry, it is necessary to control it through some responsible agency which in most countries is the Central Bank.

SUMMARY

Meaning of Credit. Credit may be defined as protracted exchange, that is, exchange of present wealth for future wealth. The fundamental elements of credit are *confidence* and *time*. All credit transactions are based on the confidence in the ability of the borrower to return what he owes together with any agreed interest payments and also in his willingness to make such payments. They are helped by the stability of political institutions, the general economic conditions and the laws of each country.

Instruments of Credit. Bills of Exchange and Banker's Drafts are discussed in the chapter on Foreign Exchange. A Promissory Note is an unconditional promise in writing to pay a certain sum of money at a stated time. It is frequently used by borrowers of money and circulates within a very narrow field. A bank note is a promissory note issued by a bank. It is convertible into legal tender on demand and does not bear any interest. A cheque is an order

1 Johnson—*Money and Currency,* p. 53.

2 Vakil and Muranjan—*Currency and Prices in India,* p. 525.

3 Also read Evit—*A Manual of Foreign Exchange,* pp. 16-18.

drawn on a bank by an individual holding a deposit with it and calling upon it to pay a specified sum of money to the bearer or the person named on the cheque. It resembles a bank note in all *essential* respects except that while the former may be drawn for an odd sum, the latter is always drawn in round figures. To avoid payment being made to wrong persons cheques are generally crossed with two parallel lines being drawn across them with the words "& Co." written in between. A crossed cheque cannot be cashed. It can only be credited to the account of the holder. Cheques are generally risky. Everybody accepting them does so at the risk of fraud aud bankruptcy. Book Credit is an entry in the books of the sellers indicating the articles and date of sale. It is safe and convenient except when debtors hold up payments for long periods resulting in heavy losses to the creditors. To guard against such emergencies, sellers generally charge higher prices from those buyers who are not likely to be prompt in the settlement of their accounts.

Characteristics of Credit Money. It must be issued by people who can inspire confidence. Credit instruments must be convenient in size and shape and difficult to counterfeit. They possess no intrinsic value, have limited circulation and are rarely hoarded.

Is Credit Capital ? No, credit is not capital nor a factor of production in the same sense as land and labour are. Credit is only a *method* of production just like division of labour. It does not create wealth but simply transfers it. If in this act of transfer it makes wealth *more productive* there may be some justification in regarding it as capital.

Advantages of Credit. It finances the producer who is engaged in turning out goods in anticipation of demand. It enables those who have saved to invest their savings and obtain an income. It is a convenient means of payment and permits economy in the use of precious metals.

Evils of Credit. When borrowed for unproductive purposes, loans are often misused. Even in production, borrowers are more inclined to play with the money of others than with their own. Thus, credit encourages wasteful and reckless expenditure on the part of individuals as well as governments and help them to mislead the public by concealing their weaknesses. The creation of credit by bank deposits is left to the discretion of the bankers who may be tempted to issue it beyond the limits of safety. Over-issue of notes by central banks may lead to a rise in general price level, unsound trade activity, speculation and ultimate crash. Unwise contraction of notes, on the other hand, may have equally disastrous consequences. It may intensify depression or precipitate a crisis. It also leads to capitalistic exploitation and extermination of small-scale producers.

QUESTIONS

1. What is credit ? Describe its nature and the forms in which it is expressed. (Punjab B A. 1931); (Delhi Int. 1932).

2. Distinguish between money and credit instuments. What are the advantages of credit to modern commerce and industry ? (U. P. Board Int. 1933).

3. Distinguish between a cheque and a bank note. "The use of cheque involves the element of belief to a much greater extent than that of the bank note." Explain how ? (U. P. Board Int. 1933).

4. "Can Credit Create Capital ?" (Delhi Int. 1930). (Calcutta B. A. 1923).

CHAPTER V

VALUE OF MONEY—INDEX NUMBERS

Meaning of the Value of Money. While recounting the services of money to mankind we had observed that the use of money may lead to great peril and confusion if its value does not remain stable. We shall now study that point a little more in detail. The expression "value of money" is used in various senses. In the first place, it is used to denote the rate of interest or the rate of discount which is nothing but a reward for lending money for long or short periods respectively. It is also used to indicate the value of the monetary unit of one country in terms of the monetary unit of another which is more popularly called the rate of exchange and which is more fully discussed in the chapter on foreign exchanges. But for our purpose in this chapter we shall use it to refer to the ability of money to command other goods and services in exchange. In this sense the value of money is analogous to the value of anything else. Just as the value of bread, cloth etc., may increase in the sense that the amount of money demanded in exchange has increased, similarly, the value of money may be said to have increased if the amount of things in general which will be given in exchange for a given unit of money, has increased. Thus while, the value of commodities is measured in terms of money, changes in the value of money must be measured by the upward and downward movement of prices in general. Such changes are spoken of as variations in the general level of prices or, as a rise or fall in the purchasing power of money. To use a mathematical phrase, prices are the ratio between the value of money and other commodities and may be altered by a change either on the side of money or on the side of commodities.[1]

It should also be remembered that though goods and money have many reciprocal characteristics, there are some vital differences between them. In the *first* place, while goods are subject to diminishing utility, money is not. *Secondly,* as regards the majority of commodities, demand is elastic in some cases, inelastic in others but rarely so balanced that the same sum is always spent on any one. The case of money is peculiar in that the total amount of goods offered in the market is not affected by its value. In other words, the demand for money is unity. *Thirdly,* the utility of goods can only be derived by possession. Money, on the other hand, to yield its greatest utility must, under normal circumstances, be dispossessed,

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1 Layton and Crowther—*An Introduction to the Study of Prices,* p. 8.

that is, must be parted with. *Lastly,* goods may have value in the absence of money ; money cannot have value in the absence of goods. Under modern circumstances, therefore, the act of acquiring goods requires that the owner parts with money. Thus it is clear that the determination of the value of money is merely a special case of the determination of general value. This aspect of the matter has, however, been discussed in the next chapter.

Importance of Fluctuations in the Value of Money. Under the complex conditions prevailing in the modern world, all complicated stages of a business transaction are rarely completed at one time. In the majority of cases they involve contracts expressed in terms of money, their settlement being deferred over widely varying periods of time. It is, therefore, desirable to have a correct idea of the extent of the variations in the purchasing power of money to fix the value of deferred payments and to correct the hardships to debtors or creditors, to wage earners or to those in receipt of fixed rents and incomes which often arise from such variations in price levels. Comparisons in the purchasing power of money at different periods of time, throw considerable light on the economic condition of different classes and enable us to form a fairly correct idea of a rise or fall in the standard of comfort.[1] A few examples will make it clear. Suppose a man earns about Rs. 50 a month. He is able to buy just as many commodities as are urgently required for himself and his family. If the prices of commodities go up, or what comes to the same thing, if the value of his money decreases he will be able to buy fewer commodities only and thus starve his family of some of the most essential necessities of life. Similarly, if a man lends Rs. 100 at a time when prices are low and gets them back when prices are high, he actually receives *less purchasing power*, or fewer commodities, than what he had originally parted with. Hence, when the purchasing power of money changes, either the debtor or the creditor loses more than justice demands. "Men sow where they do not reap and reap where they do not sow."[2]

Measurement of Price Changes—Index Numbers. The usual method of measuring changes in price (and the purchasing power of money) is by means of Index Numbers. The Index Number shows, at a glance, variations in the prices of articles in general—called price level—as well as of individual commodities with corresponding changes in the value of money. It is a number which represents the price of a chosen commodity, or group of commodities, at a selected date (called the *base*) which is used as a standard wherewith we may compare the price of the same article at a later date. Suppose that wheat, cloth, sugar, rice and ghee are the articles selected and that we wish to ascertain how much the value of money changed with respect to those since 1925. Now, suppose that wheat has risen from Rs. 5 to Rs. 7½ a maund, cloth

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1 Also read end of Chaper VI.

2 Foster and Catchings—*Money*, p. 23.

from Re. 1 to Rs. 1-8-0 a yard, sugar from Rs. 20 to Rs. 25 a maund, rice has fallen from Rs. 20 to Rs. 15 a maund and ghee from Rs. 50 to Rs. 40 a maund. It is quite obvious that whereas the value of money in respect of the first three commodities has *declined* (owing to rise of their prices), it has *increased* in respect of the last two. It will also be noticed that the degree of the rise and fall is also not the same. In order, therefore, to ascertain whether the value of money, on the whole, has increased or decreased and the degree of this rise and fall, we would represent the price of each article in the basic year (1925) by 100 and call it the Old Index Number and represent the price of the same article in the subsequent year (1935) by a figure (hereinafter referred to as the New Index Number) which bears the same ratio to the Old Index Number as the latter price bears to the former. The sum of new index numbers divided by the number of articles will give the average for 1935 and the difference of this average from the basic index number (100) will show the change in prices during the period under discussion.

We may illustrate the construction of index numbers by the table below—called the Index Number Table.

It is clear from the table that the prices, on the whole, (or the general price level) have increased from 100 in 1925 to 116 in 1935[1]

Articles	1925		1935	
	Price	Old Index Number	Price	New Index Number
Wheat	Rs. 5 a md.	100	Rs. $7\frac{1}{2}$ a md.	$\frac{100\times 15}{2\times 5}=150$
Cloth	Re. 1 a yd.	100	Rs. $1\frac{1}{2}$ a yd.	$\frac{100\times 3}{2}=150$
Sugar	Rs. 20 a md.	100	Rs. 25 a md.	$\frac{100\times 25}{20}=125$
Rice	Rs. 20 a md.	100	Rs. 15 a md.	$\frac{100\times 15}{20}=75$
Ghee	Rs. 50 a md.	100	Rs. 40 a md.	$\frac{100\times 40}{50}=80$
Index Number	5) 500 / 100		5) 580 / 116	

1 The figures are purely imaginary.

i.e., by 16 per cent. We can also say that while in 1925, 100 units of money could purchase the five articles given in our list, in 1935, 116 units would be required to purchase them. Hence the purchasing power of money has fallen by 16 per cent.

Difficulties in the Way of Constructing Correct Index Numbers. The index number tables are not easy to construct with sufficient degree of accuracy.[1] The selection of the *basic year* is of the foremost importance because if an abnormal year of uncommonly high or low prices is chosen it would tend to mislead the average reader regarding the rate of increase or decrease of prices of other years. It has become customary in many economic comparisons to take 1913 as the basic year except in so far as it is the last year before the Great War when the prices were more or less stable all over the world. The official basic year in India is 1873. Some economists take the average price of a series of years as a more correct base, *e.g.*, the prices prevailing in 1945-50 constitute the basis of the *Economist* index numbers but the advantages derived from this course seem to be doubtful.[2] It is not always possible to obtain reliable figures of retail prices. Consequently, calculations are often based on changes in wholesale prices although it is well-known that they are not necessarily accompanied by changes in retail prices. Moreover, one can never be certain that the things whose prices one is comparing are always of the same *quality*. Another difficulty arises from the constant shifting of human wants. Articles of great consequence in one period may lose their importance in the next and may even cease to be consumed at all. Again, *all* articles are not necessarily wanted by *everybody* and our estimate of the rise or fall of the value of a *particular* class may be completely wrong if it includes commodities not generally consumed by *that* community or if it does not include articles which constitute an important part of the consumption of *that* class of people. In other words, index numbers must be made with a definite purpose in view. If they are intended to measure changes in the value of money in the most general sense for a particular country they must include, in addition to all important articles of consumption, things like land and houses and the cost of service of education, railways and domestic servants etc.[3] But for the purpose of throwing light on changes in the cost of living of different sections of the society the selection of commodities must be different in different cases. It must also be emphasised that the index numbers are mere averages. The rise in the price of one commodity may be offset by a corresponding fall in that of another but the people may be more seriously affected by the former than they are relieved by the latter.

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1 Cf. Marshall—"a perfectly exact measure of value is not only unattainable but even unthinkable." Robertson has also expressed the same view. Read his *Money*, p. 27.

2 See 1905 volume of Government of India's Index Numbers.

3 Sauerback's list includes 37 articles, Soetbeer's 114, while the *Economist's* Index Number is based upon the average of 22 articles.

Weighted Index Numbers. While calculating the average price of any year some statisticians do not attach the same importance to all commodities. For, if wheat prices rise 50 per cent over the basic year and ivory prices fall to an equal extent, it will be obviously unfair to average the two and declare that prices as a whole have been unchanged. The part of ivory in our total trade is insignificant when compared to that of wheat. Consequently, a commodity which is more important in consumption or trade of a country receives greater "weight" in accordance with its relative importance for the particular object in view. For example, if the value of wheat consumed in a country is four times the value of sugar and twice the value of cotton, the number 100 will be assigned to sugar, 200 to cotton and 400 to wheat. This sort of average is called the "weighted" average to distinguish it from the arithmetical average which is ordinarily used. Let us assume that the value of the five articles in the previous table is not the same and that they are consumed in the ratio of 5, 4, 3, 2, 1. The form of the previous Index Number Table will have to be changed as follows :—

Articles	1925		1935	
	Prices	Old Index Number	Prices	New Index Number
Wheat	Rs. 5 a md.	5×100=500	Rs. 7½ a md.	$5\times\frac{100\times15}{5\times2}=750$
Cloth	Re. 1 a yd.	4×100=400	Rs. 1½ a yd.	$4\times\frac{100\times3}{2}=600$
Sugar	Rs. 20 a md.	3×100=300	Rs. 25 a md.	$3\times\frac{100\times25}{20}=375$
Rice	Rs. 20 a md.	2×100=200	Rs. 15 a md.	$2\times\frac{100\times15}{20}=150$
Ghee	Rs. 50 a md.	1×100=100	Rs. 40 a md.	$1\times\frac{100\times40}{50}=80$
Total Units=5+4+3+2+1=15				
Index Numbers=	15) 1500 100		15) 1955 130·3	

The rise of prices according to this calculation is 30·3 per cent as against 16 per cent. found on the basis of unweighted index numbers. The weighted index numbers, therefore, give a more correct view of the rise or fall of prices (and conversely of the decrease or increase in the purchasing power of money) but, in actual practice, reliable statistics of total expenditure are not available and the

relative quantities of different commodities consumed change considerably between one period and another. Hence, even some of the mathematical economists have expressed themselves against the system of "weighting". Edgeworth, for example, does not consider weighting of much importance and Giffen has expressed the same opinion.[1] Some of our best-known index numbers, *viz.*, those of the *Economist*, Jevons, Soetbeer, and Sauerbeck are based on unweighted average.

Other Methods of Making Index Numbers. It will be noticed that we have so far used the "arithmetic" mean for the measurement of price changes. "Geometric" mean and the "mathematical" mean may also be employed for the same purpose. The "geometric" mean is obtained with the help of logarithms. It mitigates the misleading effect on the index numbers from extraordinary fluctuations in price of a single article and is, therefore, quite reliable.

Another method employed by some statisticians is the use of the median. The different price quotations (reduced to a uniform base, say 100) for any year are arranged in numerical order and the middle figure, that is, a figure on either side of which there is an equal number of quotations, is found out.

Thus if a series of price quotations, reduced to the basis of 100 were

85, 90, 95, 100, 105, 110, 115,

the median would be 100.

Here we have got an odd number of figures and the median can be easily found. If there were even numbers, the median would be between the two middle figures. For instance, if the price quotations stood as follows :—

85, 90, 95, 100, 105, 110, 115, 120

the median would be rather indefinite. It would be between 100 and 105. When there are many figures, as is always the case with price quotations, the median is sufficiently accurate.

Making of Index Numbers in India. After private attempts at presenting reliable index numbers had failed the Department of Commerce and Industry of the Government of India began to issue an official publication upon price-movements entitled "Index Numbers of Indian Prices" in 1906. It dealt with wholesale prices and contained 39 articles with 1873 as the basic year. This basis was subsequently changed to 1914 and then to 1929. It was of the unweighted type. Messrs. Vakil and Muranjan regarded this procedure as most unsuitable to the case of a country like India. "In India, the annual wealth derived from agriculture is several times as large as that derived from all other sources. Even this total agricultural wealth is made up predominantly by certain staple commodities, while others are comparatively insignificant. The equal importance assigned to each of these 39 commodities has imparted to these series a

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1 See the *Report of British Association*, 1888, p. 184.

most undesirable bias . . . . Among the different classes of goods themselves, the total share in the trade and commerce of the country is most unequally divided. Rice, wheat and sugar claim more than half the share of the total trade in foodstuffs. Cotton and raw jute account for more than a third of the trade in raw materials. A similar dominant position is occupied by cotton goods among manufactured articles...In addition to all these forces, we must take into account the fact that different goods are sensitive in different degrees to changes in economic conditions".[1] Under the circumstances, they came to the conclusion that "no index number of Indian prices can be regarded as reliable which is not based on some fair adjustment of the relative importance of the sectional market".[2] The inadequacy and unreliability of Indian price statistics had been a subject of comment by many committees and commissions of enquiry. The Indian Economic Enquiry Committee of 1925 had made many suggestions for the improvement of price statistics and had recommended the passing of Census and Statistics Act. The Whitley Commission on Indian Labour had fully endorsed these views. The Bowley Robertson Committee had also condemned the then existing system and had suggested that a new index based on the model of the English Board of Trade should be tried.[3]

The outbreak of the Second World War brought to the forefront the need for better compilation of price statistics, and the Economic Adviser to the Government of India proposed the week ended August 19, 1939, as the base for compilation of index numbers of wholesale prices in India by groups of articles. This was a sensitive index. Subsequently, another index for general purposes was also introduced with the year ended August 1939 as the base.

Index numbers are specially prepared for the purpose of comparing the cost of living of the different sections of people in different periods. Such index numbers are called Cost of Living Index Numbers. A specimen of a Cost of Living Index of the working classes in Bombay is given on page 39.

The figures show that whereas the prices of cereals and pulses decreased, the cost of fuel, lighting, clothing and house rent increased. The prices, on the whole, fell from 100 to 98 (*i.e.*, by 2 points) proving that the working classes were slightly better off in April 1935 than just before the War (July 1914).

Similar statistics are maintained in some other towns *e.g.*, Ahmedabad, Sholapur, Nagpur etc. It is highly desirable that cost of living index should be prepared in other important towns also, especially where wage payments are mostly on a cash basis, in order that public opinion may be well informed in matters of labour disputes involving wages.

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1 Vakil and Muranjan—*Currency and Prices in India*, p. 40.

2 Read also pp. 299-301.

3 *A Scheme for an Economic Census of India*, 1934 p. 44.

BOMBAY WORKING CLASS COST OF LIVING INDEX (July 1914—100)[1]

Articles.	Unit of Quantity.	Annual consumption (Mas units) (in crores) (Weights)	Price per unit of quantity. July 1914	Price per unit of quantity. April 1935	PricexMass-Unit July 1914	PricexMass-Unit April 1935
			Rs.	Rs.	Rs.	Rs.
Cereals—Rice	Ind. Md.	70	5·594	3·104	392·58	217·28
Wheat	,,	21	5·594	3·911	117·47	82·13
Jo...ari	,,	11	4·354	3·573	47·89	39·30
Bajra	,,	6	4·313	3·500	25·88	21·00
Total—Cereals					582·82	359·71
Index Nos.—Cereals	......	......	...	...	100	62
Pulses—Gram	Ind. Md.	10	4·302	3·990	43·02	39·90
Turdal	,,	3	5·844	5·698	17·53	17·90
Total Pulses ...	...	...	...	...	60·55	56·99
Index Nos.—Pulses	...	...	...	...	100	94
Other food articles—	Ind. Md.					
Sugar (refined) ...	,,	2	7·629	10·714	15·24	21·43
Raw Sugar (gur) ...	,,	7	8·557	8·927	59·90	62·49
Tea ...	,,	1·40	40·000	49·146	1·00	1·23
Salt ...	Seer	5	2·130	2·953	10·65	14·77
Beef ...	,,	28	0·323	0·354	9·04	9·91
Mutton ...	Ind. Md.	33	0·417	0·668	13·76	18·74
Milk ...	,,	14	9·198	12·698	128·77	177·77
Ghee ..	,,	1½	59·792	66·073	76·19	99·11
Potatoes ...	,,	11	4·479	5·953	49·27	65·48
Onions ...	,,	3	1·552	2·974	4·66	8·92
Cocoanut oil ...	,,	1½	25·396	13·696	12·70	6·85
Total—Other food articles	...	...	...	...	381·18	486·70
Index Nos.—Other food articles	...	...	...	...	100	128
Total-All food articles	...	...	...	...	1,024·55	903·40
Index Nos.—All food articles	...	...	...	...	100	33
Fuel and lighting—						
Kerosene oil ...	Case	5	4·375	6·094	21·88	30·47
Firewood ...	Ind. Md.	48	0·792	1·073	38·02	51·50
Coal ...	Ben. Md.	1	2·542	0·495	0·54	0·50
Total-Fuel and lighting	...	...	...	...	60·44	82·47
Index Nos.—Fuel and lighting	...	...	...	...	100	136
Clothing—Chudders	Lb.	27	0·591	0·635	16·04	17·15
Shirtings ...	,,	25	0·641	0·823	16·03	20·58
T. Cloths ...	,,	36	0·583	0·625	20·99	22·50
Total Clothing ...	...	...	...	...	53·06	60·23
Index Nos.—Clothing	...	...	...	...	100	114
House rent ...	Per Month	10	11·302	117·357	113·03	178·57
Index Nos.—House rent	...	...	...	...	100	158
Grand Total ...	...	...	...	...	1,251·07	1,224·67
Cost of living Index Number ...	...	...	...	...	100	98·4

[1] This index number which was hitherto compiled on a pre-war basis was revised during 1937, the base adopted for the new series being July 1933 to June, 1934 = 100.

SUMMARY

Meaning of the "Value of Money." It may mean the rate of interest which is the reward (price) for the use of money. It may also imply the number of units of the money of one country. In this chapter the "value of money" has been interpreted to mean the exchange value of money in respect of goods (and services) within the country.

Measurement of Changes in the Value of Money. Changes in the value of money are measured by means of Index Numbers. An index number is a device for ascertaining the average rise or fall of prices of a number of commodities. Prices are quoted in all kinds of denominations—wheat per maund ; cloth per yard ; and shoes per pair. Such quotations are incomparable with one another and the index number serves to reduce them to a common base. Prices in a particular year—called the base—are taken and represented by 100 (old index number). Then the prices of subsequent years are found and represented by figures which bear the same ratio to the old index number as the latter prices bear to the former. The sum of index numbers divided by the number of commodities gives the average for two years and incidentally shows average rise or fall of prices.

Difficulties in the Way of Constructing Index Numbers. (1) Difficulty of selecting a proper basic year for an abnormal year may prove misleading for comparisons. (2) Difficulty of getting correct figures of retail prices. Hence, in compiling index numbers, wholesale prices are usually employed although their changes are not adequately reflected in retail prices. (3) Difficulty of selecting commodities whose prices are to be incorporated in the index number formula since it is clearly impossible to include the prices of all commodities. This difficulty is overcome by making different calculations for different people and for different purposes because then only those articles may be included which have a bearing on the problem at issue.

Weighted Index Numbers. All articles are not equally important. In order to bring out their relative importance, the ratios of the value of commodities consumed in a fixed period of time are found and multiplied by the index numbers. For example, if the value of wheat consumed in a country is four times the value of sugar and twice the value of cotton, the number 100 will be assigned to sugar, 200 to cotton and 400 to wheat. In actual practice, reliable statistics of total expenditure are not available and the relative quantities of the different commodities consumed change considerably beetween one period and another. Hence, many eminent economists have abandoned 'weighted' in favour of ordinary index numbers.

Other Methods of Making Index Numbers. In addition to the "arithmetic" mean, we can also use "geometric" mean and the "median" for measuring price changes.

Making of Index Numbers in India. They are compiled and issued by the Government of India. "The Index Number of Indian Prices" contains 39 articles with 1873 as the base. It is not weighted and has, therefore, been adversely criticised by Vakil and Muranjan in their *Currency and Prices in India.* According to them, agriculture in India is by far the most important industry and some staple agricultural products are much more important than others. Moreover, different goods are sensitive in different degrees to changes in economic conditions.

Cost of Living Index Numbers. Index Numbers are especially employed for the purpose of estimating changes in the standard of living of the same class of people in different periods. A specimen of the Cost of Living Index of the working class of Bombay is given. It is weighted.

QUESTIONS

1. What is meant by the "Value of Money" ?

2. What is an Index Number ? Explain carefully the method of constructing a simple index number and point out the use of index numbers for economists and businessmen. [Agra B.A. 1932 and 1934].

3. What precautions are necessary in using index numbers as a test of changes in the purchasing power of money ? [Calcutta B.A. 1927].

4. Explain the importance of "weighting" in constructing index numbers and examine its practical difficulties.

5. What do you mean by Cost of Living Index Numbers ? Construct a Cost of Living Index to show the difference in the standard of living of the factory labourers of your province since the War.

6. Write a critical note on the making of index numbers in India.

CHAPTER VI

VALUE OF MONEY—*(contd.)*

QUANTITY THEORY OF MONEY

Having seen how changes in the value of money are measured, we proceed to determine the causes of such fluctuations. It has already been pointed out in the previous chapers that money, broadly speaking, is akin to any other commodity and that, as such, its value is determined by the same forces *viz.*, demand for it and supply of it available.

Demand for Money. The demand for money, which is essentially dependent upon the habits and customs of each community, consists in the total volume of business transactions of all kinds which have to be performed within a given time with the aid of all kinds of money. More money, for instance, will be required, other things being equal, in a country where the number of articles produced (and to be exchanged) is greater than where the number of such articles is smaller. In simple words, the demand for money consists of commodities on sale.

The demand for money, in any given community at any given time, is constant in the sense that it will not change with any variation in prices. Whether goods sell for less or more all of them will be sold and will still be offered for money. Hence when there is twice as much money, the same number of commodities will be offered for the money and prices will be twice as high as before.[1]

Supply of Money. By the supply of money is meant the quantity of money units available for use as a medium of exchange. It includes all forms of means of payment—coins, notes and deposits—in possession of the public.[2] "The supply of money," says Mill, "is all the money in circulation at the time," the demand for money consists of all the goods offered for sale. As the whole of the goods in the market compose the demand for money, so the whole of the money constitutes the demand for goods.[3]

The Quantity Theory of Money.[4] The theory states—"The value of money, *other things being the same,* varies inversely as its

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1 Thus the elasticity of demand for money is unity.

2 It does *not* however include coins and notes held by the banks for meeting withdrawal by "cheques" and the "savings" and "fixed" deposits of banks against which cheques cannot be drawn.

3 *Principles of Political Economy*—Book III, Chapter VIII, Section 2.

4 Advanced students must read Keynes' *A Treatise on Money and Tract on Monetary Reforms.*

quantity ; every increase of quantity lowers the value and every diminution raising it in a ratio exactly equivalent." (Mill)

This is a self-evident proposition. In a primitive society, unaccustomed to credit, in which all the metallic money passes from hand to hand and each unit of money circulates once only, the quantity of metallic money determines the purchasing power of the monetary unit.

Illustration from a Simple State of Society. An example will make it clear. Suppose there are 100 commodities in a country and there are 100 rupees to purchase them with. Assuming that (*a*) each of the 100 commodities is bought and sold once, that (*b*) each of the 100 rupees is spent just once and that (*c*) there is no barter or hoarding, the price of each commodity on the average would be Re. 1. Now, suppose that there are 200 rupees with which to purchase the same 100 commodities. Making the same assumptions as before, the average price of each unit of commodity rises from Re. 1 to Rs. 2. The number of commodities which Re. 1 purchased before can now be purchased with Rs. 2. In other words, the purchasing power of each unit of money has been cut by half. But if instead of Rs. 100 there are only Rs. 50 in circulation and if all the conditions mentioned above are fulfilled the value of money is doubled. It is, therefore, obvious that an increase in the amount of money causes a fall in its value and a rise in prices ; and that conversely, a decrease in the quantity of money causes a rise in its value and a fall in prices, in each case in proportion to the change in quantity.[1]

The Equation of Exchange. The theory may best be explained with the help of an equation of exchange. Adopting the form adopted by Irving Fisher, the best exponent of the theory, let us represent the total annual expenditure on commodities in any community by E whilst the average amount of money in circulation is M. Now, it is hardly likely that the average amount of money in circulation (M) is equal to E—the total expenditure. The same monetary unit must have been used a number of times to do the requisite amount of work. The capacity of money to change hands repeatedly is called its *velocity of circulation* (or the average rate of turn-over of money) and may be calculated by dividing E by M. Hence,

$$V=\frac{E}{M} \qquad \text{or} \qquad E=MV.$$

In other words, the total circulation of money in the sense of money expended is equal to the total money in circulation multiplied by its velocity of circulation or turn-over.

In the above equation we have two sides—the "money side"

1 Note that the prices of commodities and the purchasing power of money are inversely proportional to each other.

represented by MV (*i.e.*, the amount of money in circulation multiplied by its velocity) and the expenditure or "goods side" which is represented by E. The latter requires further elucidation. Let us suppose that the average price of a particular commodity, say wheat, within the period, is represented by p while the total quantity purchased in the same period is represented by q. Then the total expenditure on that commodity will be equal to the product of these two factors, namely, pq. Now assuming that wheat is the only article on which the money is spent, the equation will read as :

$$pq = MV.$$

But, in actual practice, many more articles enter into exchange at varying prices and in varying quantities. Let us designate the average price of each by p_1, p_2, p_3, etc., and the total quantity purchased by q_1, q_2, q_3, etc. Taking into consideration all these articles and the amount expended on each, the total expenditure will be equal to $p_1q_1 + p_2q_2 + p_3q_3 \cdots\cdots p_nq_n$ or, employing Σ[1] as a symbol of summation $= \Sigma\, pq$. Since the "money side" and the "goods side" must be equal, the equation will be

$$\Sigma\, pq = MV$$

But, if all p's be represented by P and all q's by Q we will have

$$PQ = MV.$$

Further, since the number of things bought and sold (Q) may also be represented by T, the total quantity of things produced and exchanged,

$$PT = MV$$

$$\text{or } P = \frac{MV}{T}$$

P = average of all different commodity prices.
M = amount of money in circulation.
V = velocity of circulation of M.
T = total volume of trade affected.

Put in this form, the theory states that assuming T and V to be constant, prices vary directly as M. In other words, the price level (P) varies (1) directly as the quantity of money in circulation (M) ; (2) directly as the velocity of its circulation (V) ; and (3) inversely as the volume of trade done by it (T).

Example Modified to Suit Modern Conditions. In the complex world of to-day, however, conditions are slightly different. In addition to metallic coins, there is a considerable amount of bank money always in circulation and owing to improvements in means of transport and extension of banking facilities, each unit of bank money changes hands more than once. Representing bank money by M_1 and its velocity of circulation by V_1 the above equation may be amended as follows :

$$P = \frac{MV + M_1V_1}{T}$$

1 Σ means "sum of all such as."

Now in a given community there is a definite relation[1] between the money in circulation (M) and the bank money withdrawable by means of cheques (M_1) so that if there is a change in M there will be a proportionate change in M_1 leading to an exactly proportional change in the general level of prices.

We are now in a position to understand the true significance of the words " other things being the same " used by Mill in his definition of the Quantity Theory. " Other things " include the rapidity of circulation of money, the proportion of business done by barter and on credit, the condition of trade and the amount of business done.

The Quantity Theory of Money holds good if these " other things " remain unaltered but if there is a change in them P will be affected not by M alone but by all other factors mentioned on the right-hand side of the equation, *viz.*, M_1, V, V_1 and T. To put it more simply, we might say :

(1) the prices vary directly as the quantity of money (M and M_1) provided the volume of trade (T) and the velocities of circulation (V and V_1) remain unchanged ;

(2) that prices vary directly as the velocities of circulation (if these velocities vary together) provided, the quantity of money (M and M_1) and the volume of trade (T) remain unchanged ; and

(3) that prices vary inversely as the volume of trade (T) provided the quantity of money (M) and, therefore, the bank deposits (M_1), and their velocities (V and V_1) remain unchanged.

Thus there are five influences (M, M_1, V, V_1 and T) which directly influence the level of prices. Any other influences on prices must act through these five. Outside influences acting through T are :—

(*a*) the differentiation of human wants ;
(*b*) diversification of industry ; and
(*c*) rapid transportation.

Those that act through V and V_1 are :—

(*a*) improvident habits ;
(*b*) use of book credit ;
(*c*) rapid transportation ;

1 "In a given community the quantitative relation of deposit currency to money is determined by several considerations of convenience. In the first place, the more highly developed the business of a community, the more prevalent the use of cheques......................Again the more concentrated the population, the more prevalent the use of cheques. In cities it is more convenient, both for the payer and the payee, to make large payments by cheques ; whereas in the country, trips to a bank are too expensive in time and effort...........and, therefore, more money is used in proportion to the amount of business done. Again the wealthier the members of the community, the more largely will they use cheques". Fisher—*The Purchasing Power of the Money,* pp. 51-52.

Those that act through M are :—

(*a*) import and minting of money ;

(*b*) bimetallism which introduces two metals in circulation ;

(*c*) issue of bank notes.

Those that act through M_1 are :—

(*a*) extension of the banking system ;

(*b*) use of book credit.[1]

Criticism of the Theory. The Quantity Theory of Money as stated above has come in for much adverse criticism. It has been said, for instance, that there is nothing new in it.[2] That the money given in exchange for goods is equal to the price of those goods is a self-evident proposition and does not require much logical reasoning. It is also pointed out that the factors which have been assumed to be constant are rarely constant even in short periods and that these factors are not independent variables. For instance, a change in M is likely to bring about changes in V and T and so are changes in V, T and P likely to be accompanied by changes in other factors.[3] Moreover, M′ does not bear a constant relation to M.

Bank deposits are no longer rigidly connected with a certain definite percentage of cash reserve. Another objection to the Fisher's Equation is to be found in its neglecting to take explicit account of the distinction between Cash-deposits and Savings-deposits and of the use of overdraft facilities. Moreover, it does not explain the *process* by which the quantity of money brings about a change in the price-level nor does it afford a satisfactory explanation of the behaviour of prices during trade cycles. Prices during the slump (depression) fall even when the supply of money remains unaltered and recover in the period of boom without any increase in the amount of money in circulation.[4] This incidentally proves that price is not a purely monetary phenomenon.

Lastly, as Keynes has pointed out, a large majority of transactions taking place through money are industrial, commercial and

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1 Irving Fisher—*Purchasing Power of the Money*, pp. 149-150.

2 For earlier views, read Lewinsky—*Money, Credit and Prices*, pp. 81-95.

3 "Most authors imagine that the monetary wheel is connected by a belt exclusively with the wheel of prices, while all other parts are unaffected by movements of M and P. Such a theory is completely wrong and artificial representation of the real mechanism. All its parts are inter-related. M is not only setting in motion P but equally T, V, V′ and the relation of M to M′. The wheels are not only turning from left to right, but we have equally movements in the opposite direction. When P is changing, velocities are adapting themselves to the modified conditions most easily.......P is influencing T, production increases and decreases according to the state of prices. M itself is partly regulated by P." Lewinsky, pp. 35-36.

4 For a very illuminating discussion of this point read Crowther—*An Outline of Money*, pp. 103-128.

financial. Only a small proportion of them are commodity transactions which are represented by T in the equation. The equation thus measures not the purchasing power of money but the cash-transactions standard.

In fairness to Fisher it must be admitted that he has not ignored the effects of the changes in the quantity of money on the velocity of circulation or on the volume of transactions. All that he has asserted is that such changes are only possible in abnormal times or during periods of transition. Under abnormal conditions, and in the long run, changes in the quantity of money will cause exactly proportional changes in the price-level.

Moreover, as Keynes has admitted, for quantitative inquiries it is possible to make more progress with this formula than with any other. MV corresponds, more or less, to the volume of Bank Clearings and M to the Volume of Deposits, for both of which figures are available, so that the volume of V can be easily deduced.[1]

Other Theories of Money. Fisher assumed the demand for money as being derived from the goods to be sold for money. Marshall, Pigou, Keynes etc., have however, pointed out that the demand for money is constituted by the people's demand for ready purchasing power for the purpose of meeting their personal and business expenditure and for meeting future contingencies. They feel that the demand for money is *indirect.* Money is not wanted for its own sake but only as a medium of exchange. It is just like a railway ticket which is not bought for the fun of holding it but as a means of reaching a certain destination. The possession of money offers certain advantages which must be put against the disadvantages of holding other forms of wealth. The result of this comparison decides which part of the real income of the community (expressed in terms of goods such as maunds of wheat or tons of coal) will be held in the form of money. The establishment of this relationship also helps to determine the value of money.

The "Real Balances" Quantity Equation. In his *Tract on Monetary Reform*, Keynes has developed a theory on these ideas[2] and has produced the following equation :—

$$n=p(k+rk').$$

1 *Treatise on Money*, Vol. I, p. 235.

2 Which, in his own language, are "that what a holder of money requires is a quantity of real balances which bears the appropriate relationship to the quantity of real transactions upon which he employs his balances. If this appropriate relationship remains unchanged the quantity of cash-balances which he needs will be equal to the quantity of Real-balances as determined by the above 'appropriate relationship,' multiplied by the price-level 'corresponding to the prices applicable to the various real transactions against which the cash-balances are held." He has measured Real-balances by consumption units *i.e.*, units made up of a collection of specified quantities of standard articles of consumption or other articles of expenditure.

Here n=total quanlity of cash ;
r=proportion of the bank cash reserves to their deposits ;
p=price of consumption unit ;
and k & k'=number of consumption units which the public require in cash and in bank deposits, respectively. Their amounts depend partly on the wealth of the community and partly on its habits which are themselves determined by its estimation of the extra convenience of having more cash in hand as compared with the advantages to be got from spending the cash or investing it.

This method of approach is certainly more realistic because *firstly*, it emphasises that the price-level depends on the people's habits about holding a proportion of their incomes in the form of readily available purchasing power, and *secondly*, because it brings out the importance of the decisions of the bankers regarding the amounts of their reserves and the decisions of the depositors regarding the proportion of their incomes to be kept in the form of cash or bank-deposits in the determination of prices.

But the fault of this treatment lies in assuming that the cash-deposits are used for expenditure on current consumption only whereas in actual practice they are held for a vast multiplicity of business and personal purposes.

Its second fault lay in the suggestion that the possible causes of variation of k' were limited to those which can be properly described as a change of habit on the part of the public. This use of language was not formerly incorrect ; but it is misleading in so far as it is intended to include, for example, a change in the proportions of the total deposits represented by Savings-deposits, Business-deposits and Income-deposits respectively due to a change in bank-rate or in the business situation as a whole.[1]

In his *Treatise on Money*, therefore, Keynes admitted that "the merging together of all the different sets of transactions—income, business and financial—which may be taking place, only causes confusion and that we cannot get any real insight into the price-making process without bringing the rate of interest, and the distinction between incomes and profits and between savings and investments."

The "Cambridge" Quantity Equation. Marshall and Pigou, following the line of treatment indicated by Petty, Locke, Cantillon and Adam Smith, have presented the same ideas in the form of an equation usually known as the "Cambridge" Equation.

Suppose R stands for the real income of the community, K for the proportion of R held in the form of money, and M for the

1 *Treatise*, pp. 223-24.

number of units of money. Then M will be equal to KR or the value of money per unit will be $\frac{KR}{M}$.

Since the value of money varies inversely with prices, p, the price-level, will be equal to $\frac{M}{KR}$.

Suppose R=100 maunds of wheat, K=½, and M=Rs. 500. Then the value or the purchasing power of a rupee$=\frac{100\times\frac{1}{2}}{500}=\frac{1}{10}$ maunds of wheat, or p (the price-level)$=\frac{500}{100\times\frac{1}{2}}=$Rs. 10 per md. of wheat.[1]

Some economists have pointed out a marked similarity between this and Fisher's equations. The position will appear clearer if we put the two equations side by side :

$$MV=PT \quad \frac{M}{K}=pR.$$

The apparent similarity is, however, deceptive. In the *first* instance, P and p are not the same things. P denotes the price-level of all those things which enter into a transaction settled with money, while p stands for the prices of those things that form part of the community's real income. *Secondly*, R is not the same thing as T. The monetary transactions (T) referred to in Fisher's formulae include all types of industrial, commercial and financial transactions but in the Cambridge equation R includes only those goods which the members of the community buy to consume or to use or to enjoy (and not those things that they buy to sell again or to help them make things to consume).

The juxtaposition of the two equations does show, however, that V and K tend to be the opposites of each other. When K rises, V falls and *vice versa*. A rise in K means that people want to increase their holding of money or that the demand for money increases. From a different angle, the same change means a fall in the velocity of circulation of money or V. The consequences are the same as of rise in the value of money.

Even with the improvements suggested above, it must be admitted that the Quantity Theory suffers from two defects. In the *first* place, the emphasis it lays upon the quantity of money as the *only* cause of economic changes is rather misleading. *Secondly*, the assumption that changes in prices are the most important phenomenon of the economic system is also unwarranted. "It is bad trade," says Crowther, "that causes low prices...not low prices that cause a low level of trade...it would in reality be much nearer the

1 For detailed criticism, see *Treatise*, pp. 231-33.

truth to say that bad trade and low prices are equally the consequences of some common cause."[1]

Quantity Theory of Money and Trade Cycles. Nevertheless, the approach of the Cambridge Economists is better than that of Fisher, especially from the point of view of trade cycles. It emphasises that changes in price-level are not brought about by mechanical changes in the supply of money but by our habit regarding the holding of a proportion of our real income in the form of money. It is also recognised that changes in the value of money arise from changes in the demand for money rather than from changes in the velocity of circulation. Hence it gives a more satisfactory explanation of what happens during a trade cycle *i.e.*, why once the price-level goes on falling, the people increase their holdings of money and there is further fall in the price-level, or when once the price-level goes on rising, the people decrease their holdings of money and there is a further rise in the price-level. In other words, in a boom K falls and in a depression K rises.

Savings and Investment Theory. Now the rise and fall of K is determined by the relation of savings to investments. Therefore, for the purpose of studying the phenomenon of trade cycles we should not consider the total quantity of money in relation to the total number of transactions but we should rather take into account the portion of their income which people do not spend on consumer's goods, *i.e.*, the portion that they save, how these savings are turned into capital and the rate of interest which directs the flow of investment or the process of capital formation.

Income, as we know, can either be consumed or saved or both. What is saved is not necessarily invested for the hoarded savings are of no use to the community as a whole. It is only when savings are turned into investment goods (such as machines) that they add to the supply of consumption goods. If the desire to save is more there will be a proportionate reduction in the demand for consumption goods. This would have adverse effects on the investment goods industries also thereby producing unemployment and loss of purchasing power which would tend to reduce demand further. Prices will show a downward tendency. This will thus be the beginning of the downward swing of the trade cycle.

When there is an excess of investment over savings, the reverse process begins. Increased demand for durable goods leads to the employment of more labour and increased absorption of other factors of production with the result that their prices rise. But even this condition cannot last long. Increase in the prices of factors of production raises costs and reduces profit and also diminishes the desire to produce more. At the same time the bankers not only charge higher rates of interest but actually restrict loans to industry. Thus the upward swing is not only checked but turned into a

1 *Ibid*, p. 138.

downward swing. "Hence," says Brij Narain, "the Quantity Theory of Money may be invoked to explain the beginning, the continuance and also the reversal of the upward swing. For easy money conditions invariably accompany recovery, and the stiffening of money rates, or credit restriction, marks the end of a process of expanding business activity."[1] It will be seen that the Quantity Theory does not account for the slump at its worst. During the depression there is less money in circulation, but the decrease in circulation is not the cause of slump but the result of it. Hence the Trade Cycle is the causative factor and the price-level is the effect. Crowther has summed up the position in the following words: "The relationship between savings and investment governs the short-period fluctuations of employment and prices. If savings are in excess of investments then prices will tend to slump below their equilibrium level. If savings are less than investments, prices will tend to rise above their equilibrium level. But the equilibrium level itself is at least partly determined by the quantity of money in existence. The Quantity Theory of Money explains, as it were, the average level of the sea, the Savings and Investment Theory explains the violence of the tides.[2]

Rate of Interest and the Value of Money. We have seen that the value of money is governed by savings and investments but, as some of the modern economists have shown, savings and investments are themselves dependent on the rate of interest. It is, therefore, natural that the changes in the value of money should be explained by variations in the rate of interest. For this purpose, Keynes has distinguished between the "Natural" (or normal) and the "market" rates of interest. The natural rate has been defined as the rate of interest which keeps the rate of saving and the rate of investment equal.[3] Saving here means refraining from spending money incomes on consumption goods. The volume of savings is, therefore, equal to that portion of the money incomes of the community which is not spent on consumption goods. When the market rate of interest is different from the natural rate, certain factors will come into play which will affect the value of money. If, for instance, the banks charge a money rate of interest lower than the natural rate, the demand for credit will increase. If *entrepreneurs* have more money to spend, they would not only employ more factors of production but also reward them better. Hence, the incomes of the factors of production will increase and they will naturally spend more thereby raising the prices of consumer's goods. Conversely, if the market rate of interest is higher than the natural rate of interest, the demand for credit will diminish, the incomes of the factors will decrease and prices would fall. In equilibrium, the market rate is equal to the

1 *Money and Banking*, p. 22.
2 *Ibid*, p. 159.
3 Wicksell has defined the natural rate as "that rate of interest at which the demand for loan capital and the supply of savings are exactly equal".

natural rate of interest, the volume of savings is equal to the value of investment goods and the price-level of the output as a whole exactly corresponds to the money rates of the efficiency earnings of the factors of production, *i.e.*, to the cost of production per unit of output. These ideas are also illustrated by means of an equation—called the Fundamental Equation.

If E = earnings of the community in a unit of time ;
I' = cost of production of new investments ;
$\therefore E - I'$ = cost of production of the current output of consumption goods.
Also if S = amount of savings ;[1]
so that $E - S$ = current expenditure of income on consumption goods;
and O = total output in units of quantities of goods in a unit of time ;
R = volume of liquid consumption goods and services flowing on to the market and purchased by consumers ;
C = the net increment of investment in the sense that $O = R + C$;
and P = price-level of consumption goods ;
then PR is the current expenditure on consumption goods,
and $E.\frac{C}{O} = I'$ is the cost of production of new investment.

Further, since the expenditure of the community on consumption goods is equal to the difference between its income and its savings, we have

$$P.R = E - S = \frac{E}{O}.(R + C) - S = \frac{E}{O}.R + I' - S ;$$

$$\text{or } P = \frac{E}{O} + \frac{I' - S}{R}.$$

Thus, given the rate of new investment and the cost of production, the price-level of consumption goods is solely determined by the disposition of the public towards "saving". And given the volume of saving deposits created by the banking system, the price-level of investment goods is solely determined by the disposition of the public towards "hoarding" money.

Stated in this form, the theory is open to three objections. *First*, P, E and S are expressed in terms of money which means that the equation would also be satisfied if the price-level P were twice as high with the same nominal amount of money in circulation. It does not rule out the possibility that with the same quantity of money in existence, the price-level might double, become ten times as high, or even rise to infinity. There must, therefore, be some other factors which determine the rate of exchange between money and goods which find no place in the fundamental equation. *Secondly*, since R, E and S are magnitudes referring to a stipulated period of time, P is also the

1 That is the difference between the money-incomes of individuals and their money-expenditure on current consumption.

price-level during a given period (or rather the average during this period). Thus we cannot derive from them the price-level at *any* given moment. If some calamity should occur overnight—if, for example, rumours of war should appear suddenly in the morning papers, or a report be published that the circulation of bank notes has been largely increased and the export of bullion forbidden—the price-level might suddenly become very different from what it was the night before although R, E and S remain unchanged. Motives governing behaviour cannot be introduced into this kind of mechanical approach. *Thirdly,* Keynes has distinguished between the normal reward of the *entrepreneurs* and their profits. The first is included in E (the income of the community) while profits, not being part of the income of the community are not part of its savings even when they are not spent on current consumption. This is not right because, in actual practice, it does make some difference to the price-level of consumption goods, whether these profits are wholly, partly, or not at all spent on current consumption.[1]

The Quantity Theory of Money as Applied to India. It has been pointed out that prices are affected by many factors besides the supply and demand of money. In addition to the causes mentioned above, therefore, prices may rise as a result of increasing cost of coal, protective duties, establishment of monopolies, trusts or cartels and fall of exchange, etc., without being necessarily accompanied by discovery of gold or silver mines. Prof. Fisher has himself admitted that the relation between the quantity of money and the price-level does not hold good of transition periods. The words "transition periods" imply periods in which prices rise and fall. In such periods the magnitudes of the equation of exchange try to seek equilibrium. The relation between money and deposits is not rigid and prices are not wholly the result of other magnitudes of exchange. All these magnitudes react upon one another in such periods. The proportional effect of changes in the quantity of money on prices is then only the ultimate effect after transition periods are over. But the transition periods are normal features of trade and commerce. They are not exceptions. Hence the quantity theory of money holds good only under hypothetical and static conditions and not under dynamic conditions. Therefore, the Quantity Theory of Money, *in its bald form,* does not apply to India any more than to any other civilised country of the world.[2] A careful study of the currency

1 Tjardus Greidanus—*The Development of Keynes' Economic Theories.*

2 It will be interesting to remember the rise in prices in the middle of the 19th century which accompanied the discovery and working of new gold mines, and the rise which began during the early years of the 20th century before the outbreak of World War I. It is true that this last phenomenon was accompanied by a very considerable increase in gold production in Australia and South Africa but it also coincided with a whole set of new facts—a general rise in customs duties, the development of labour organizations tending to restrict competition, trusts, cartels etc. Hence, scientifically, we do not appear to be justified in holding for certain and *a priori* that there was a relation of cause and effect between this phenomenon and one of its possible antecedents after ignoring other factors which exercised an influence in the same sense and which might afford a sufficient explanation.

history of the world will show that it is impossible to discover any complete proof of the theory in a few summary comparisons in which other possible relations of cause and effect are ignored. There is rise and fall in prices but it is seldom proportionate to increase or decrease of money supply. Lord Keynes, in an article in the *Economic Journal* for March 1909, showed by means of the following table that the percentage of increase in currency in India was *very nearly* the same as that of the rise of prices during the years 1903-1907.

Year	General Index Number of Prices	Estimated total of the currency on the 1st of April of each year
1903	100	100
1904	102	110
1905	112	115
1906	131	127
1907	140	136

The following table, based on the Report of the Controller of Currency, tells almost the same tale :—

Year	Amount of currency in circulation[1]	Percentage increase or decrease of circulating media	Prices in Calcutta	Percentage increase or decrease of Calcutta prices	Prices in Bombay	Percentage increase or decrease of Bombay prices
	(in crores of Rs.)					
1920	414	100	201	100	216	100
1921	382	92	178	89	198	92
1922	381	92	176	88	187	87
1923	375	90	172	86	181	84
1924	390	94	173	86	182	84
1925	391	94	159	79	163	76
1926	384	93	148	74	149	69
1927	361	87	148	74	147	68
1928	368	89	145	72	146	68
1929	368	89	141	70	145	67
1930	328	79	116	58	126	58
1931	295	71	96	48	109	50
1932	316	76	91	45	109	50
1933	294	71	87	43	98	45
1934	307	74	88	44	93	43

1 Does not include gold and subsidiary coins and credit money.

It will be noticed that here the fall of prices is very much steeper than the reduction in the amount of circulating media proving thereby that "there are a large number of other factors, besides the quantity of money, which play a part in determining price-movements over short as well as long periods. These other factors are constantly shifting and difficult to measure and exert a greater influence than the quantity factor on the trend of prices. It still remains true to assert that the quantity of money is *one* cause amongst others whose importance may sometimes be overlooked."

Inflation and Deflation. Depreciation and Appreciation. The words "Inflation" and "Deflation" apply to the *amount* of circulating media while the terms "Depreciation" and "Appreciation" apply to the *value* of money. When the supply of money (including credit), *relatively to the demand*, increases to such an extent that the prices in general rise and the purchasing power of monetary unit increases the currency is said to be "inflated" and its purchasing power to be "depreciated". Similarly, when the supply of money is reduced *disproportionately to demand*, the currency is said to be "deflated". Deflation is invariably accompanied by fall of prices. It should be clearly borne in mind that an *ordinary* expansion of currency (and credit) such as may be rendered necessary by an increase in trade or population would *not* result in inflation. Inflation would only be caused either (1) by an abnormal or deliberate expansion of currency and credit beyond the amount necessary to supply the needs of trade at the existing level of prices, or (2) by a diminution of production, provided that the volume of currency remains unchanged.[1]

Causes of Inflation. Inflation is sometimes due to *natural* causes like a sudden increase in the output of mines or heavy importation of precious metals as was the case between 1896 and 1911 when prices rose owing to the discovery of gold mines in South Africa. But it is more often brought about *artificially* in times of grave national emergencies. For example, it is an important means of combating the continued menace of the economic depression (falling prices) in America nowadays. The most appropriate occasion for resorting to inflation is a great war like the one we had in 1914-18. War calls for expenditure vastly greater than can be met by the ordinary revenue of the State. Additional funds may be raised by borrowing which may be difficult and costly especially when the credit of the government is low. Fresh taxes may be imposed but only at the cost of the displeasure of the people. The simplest and the cheapest method, therefore, of getting more money is to put into circulation inconvertible notes which the government is not bound to redeem and on which it has to pay no interest. The huge mass of these notes increases the volume of money which is mostly employed for unproductive (war) purposes. This means that a great war

1 Kemmerer has defined inflation as "too much money and deposit currency—that is, too much currency in relation to the physical volume of business being done."—See *The A B C of Inflation*, p. 6.

carries with it not only an increased supply of money but also a decreased production and, therefore, decreased supply of commodities. The amount of money (and credit) increases much faster than the number of commodities and inevitably results in inflation. "It has been estimated that during the last Great War, and for some time after it, while there was a decrease by 10 per cent in the supply of commodities in European countries, the means of payment were generally increased by at least as many hundreds per cent.......The result of the creation of new money has been that a new buying capacity has been put at the disposal of the government. The total buying capacity of the communities having been increased in this way, without a corresponding increase in the commodities to be bought, a general rise in prices has followed. Consequently, an inflation has taken place in every one of the countries involved in the War." This method of financing war has numerous advantages. For instance, it evokes an appearance of economic prosperity and of increase of wealth and thus increases the capacity of the capitalists to pay for the war effort. It also diverts the fury of the people to "speculators" and "profiteers" and thus saves the government from a great deal of destructive and embarrassing criticism. In peace times, a government always finds itself obliged to resort to inflationary measures when it cannot negotiate loans and dare not levy taxes for fear of losing popular support. Inflation is also sometimes employed for the purpose of helping the debtors at the expense of the creditors or the exporters at the cost of the importers.

Evils of Inflation. The evils of inflation are many. When currency depreciates the creditors lose and the debtors gain because the money borrowed when it was dear is paid back when it is cheap. The interest payments become of less value to the creditors. The rise in prices results in agriculturists, manufacturers, wholesalers and retailers obtaining large profits during the rise simply by holding their stocks which rapidly increase in market price. The wage-earning classes also lose since wages seldom increase in sympathy with, and in proportion to, the rise of prices. The enhanced profits of the entrepreneurs and the increase in the cost of living, result in social unrest and labour troubles. The increased cost of production makes it difficult for the producers to compete in the markets of the world. Consumers and salaried persons also suffer because, while their incomes remain the same, they are called upon to pay higher prices for articles of consumption.[1] The artificial prosperity which accompanies inflation undermines the economic life of the country and often leads to thoughtless extravagance particularly among the profiteers. The prosperity gained from inflation is more apparent than real. "People so habitually reckon their incomes and resources in terms of money that they think themselves better off when money

1 For a detailed analysis of income-receivers according to the effects produced by a rise of prices read *An Introduction to the Study of Prices* by Layton and Crowther, p. 15 ; and Keynes—*A Tract on Monetary Reforms.*

incomes go up. They disregard, for a time at least, that their expenses go up also."[1]

A government can easily conceal the bad effects of its policies by depreciating the currency. In this sense it may be called an instrument of *unpopular*, *i.e.*, of anti-democratic policy, since by misleading public opinion it makes possible the continued existence of a system of government that would have no hope of the consent of the people if the circumstances were clearly laid before them. Another serious defect of inflation is that once it is started it is very difficult to stop. The purchasing power of money falls lower and lower until it disappears altogether. Hence, continued inflation eventually leads to collapse. In the long run, a money which continually falls in value will have no commercial utility. It could not be used as a standard of deferred payments. Moreover, "all the aims of inflationism can be secured by other sorts of intervention in economic affairs, and secured better, and without undesirable incidental effects. If it is desired to relieve debtors, moratoria may be declared or the obligation to repay loans may be removed altogether; if it is desired to encourage exportation, export premiums may be granted; if it is desired to render importation more difficult, simple prohibition may be resorted to or import duties levied.[2]

Methods of Deflation. Because inflation injures a large section of the population and robs them of a substantial part of their real income a policy of deflation is adopted to counteract its effects. Superfluous currency is pumped out of circulation either by cancelling inconvertible notes or by increasing the volume of production in the country or by heavy taxation. The Central Bank raises the discount rate to contract currency and even floats loans or sells securities to withdraw money from actual circulation.[3]

Limitations of Policy of Deflation or Restrictionism. It should, however, be remembered that the history of monetary reforms based on deflation teaches us that the value of the currency never rises in proportion to the decrease to note-circulation. The reduced amount of circulation is often insufficient in comparison with the relatively high price-level. This forces the government, which has tried to raise the value of the currency by deflation, *either* to abandon such plans (as in Russia in 1884) *or* to put again in circulation a part of the withdrawn notes (as in Czechoslovakia in 1919). Besides, if a part of the circulating medium were destroyed overnight, it is hardly likely that prices would fall equally suddenly. "Prices are not a stone wall which is quite immovable but they are not equally wax which gives way to every pressure. They offer a

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1 Taussig—*Principles of Economics*, Vol. 1, pp. 997-8.

2 Ludwig von Mises—*The Theory of Money and Credit*, p. 230.

3 The procedure is technically called Open Market Operations and has been explained in the chapter on Banking in India in connection with the functions of Central Banks and credit control.

strong resistance to all interference. If the pressure which is exercised is increased beyond a certain point, it is not prices which decline but the withdrawn currency is replaced by some other less perfect substitutes. It may be said that the amount of circulation is more elastic than the price level. It is easier to adopt the quantity of money and credit to a changed price-level than to modify prices by managing the circulation".[1]

Consequences of Deflation. Like inflation, deflation also does not help everybody. In a period of falling prices the economic effects are, broadly speaking, the reverse of those discussed in connection with rising prices. The burden of falling prices tends to press most heavily on the business or entrepreneur class, for while their gross incomes decrease the burden of taxation and wages remain practically unaffected. Heavy losses weaken productive enterprises and cause business failures and serious unemployment over the whole field of industry. The earning class benefits from a fall of prices since their money-wage purchases a large share of goods and services than before unless, of course, steeply falling prices so reduce the income of their employers (including the government) as to necessitate heavy retrenchment or cut in salaries. Similarly, in agriculture the falling prices have disastrous consequences. In the first place, the prices of agricultural products tend to decline more quickly than those of manufactured articles. The farmer, therefore, has to give a greater proportion of his produce in exchange for the manufactured goods which he buys. Secondly, the agriculturist has to wait for a much longer period than the manufacturer from the time when he commences production to the time when he can sell his produce with the result that he sustains heavy losses because crops prepared and sown at one level of prices are sold months later at a lower level. Moreover, "all incomes fixed in terms of money such as interest on the National Debt, debentures and other fixed-interest securities remain unaltered. Thus incomes derived from those sources are able to purchase an increased proportion of the national output at the lower price now prevailing...The proportion of the national output which can be purchased by these classes of recipients being increased, the amount left for distribution between the remaining sections of the community is reduced."[2] Indeed it has been said that among the many causes of human retrogression—wars, pestilence, famine, bad governments etc.—a long period of falling prices is perhaps the worst because it saps the very sources of human enterprise, deadening the desire to venture and by checking the leaders and most go-ahead sections of the community, stops national progress and jeopardises the position of the whole country.

When deflation is carried out by the withdrawal of notes from circulation, (say, through the issue of interest-bearing bonds or

1 Lewinski—*Money, Credit and Prices*, p. 53.

2 *Report of the Committee on Finance and Industry* (1931), p. 86.

through taxation) the government suffers heavy losses, especially at a time when the demand for money is increasing and the government may easily increase its income by bringing more notes into circulation. Furthermore, attempts to raise the exchange value of money by artificial means, unless followed by similar action by other countries, are bound to have an adverse effect upon international trade. In the country whose money is rising in value, exportation becomes more difficult and importation easier and the terms of trade become unfavourable. Even as a means of solving the difficulties caused by inflation the policy of deflation cannot be justified because those who are enriched by the increase in the value of money are not the same as those who were injured by the depreciation of money in the course of the inflation ; and those who must bear the cost of the policy of raising the value of money are not the same as those who benefited by its depreciation. "To carry out a deflationary policy is not to do away with the consequences of inflation. You cannot make good an old breach of the law by committing a new one. And as far as the debtors are concerned, restriction is a breach of the law."[1]

Conclusion. It will be clear from the above discussion that both *rising* and *falling* prices are bad and that their effects are experienced particularly in the *period of transition* when the relative economic status and welfare of different sections of the community are profoundly affected. "The rising prices and falling prices have each their characteristic disadvantages. The inflation which causes rising prices means injustice to individuals and classes, particularly to investors and is, therefore, unfavourable to saving. The deflation which causes falling prices means impoverishment to labour and to enterprise leading entrepreneurs to restrict production in their endeavour to avoid loss to themselves and is, therefore, disastrous to employment. The counterparts are, of course, also true, namely that deflation means injustice to borrowers and that inflation leads to the over-stimulation of industrial activity. Thus inflation is unjust and deflation is inexpedient."[2] Hence, in the interest of social justice and harmony *steady* prices are the best. They promote stability of production, trade, employment and general business conditions. They also ensure justice between debtors and creditors and between the wage-earners and the employers. "There is no nobler work for the enlightened humanity of to-day than that of controlling money and monetary policy, of regulating the supply of capital and the level of prices and the habits of consumption in the general interest of mankind."[3]

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1 Mises, *op. cit.*, p. 234.

2 Keynes—*A Tract on Monetary Reforms.* Seligman has also expressed a similar opinion. "Both rising and falling prices create an unstable equilibrium which means disturbance in industry and unequal gains or losses to different classes. It is not high or low prices as such which do the harm, but rising or falling prices."—*Principles.*

3 Wadia and Joshi—*Money and the Money Market in India*—p. 3.

(*Continued on next page*)

Reflation. It is another important term widely used in economic discussions nowadays. Cole has defined it as "inflation deliberately undertaken to relieve a depression."[1] It denotes a condition of affairs where deflation has been carried out too fast or too far. If a policy of deflation has resulted in too great a fall in prices and too great discouragement of trade and industry obviously the volume of currency and credit available has been rendered too small. A certain resort to the process of inflation may then be necessary but as the result is not inflation as such the processes used are covered by the term "reflation" to convey the distinction.

SUMMARY

The chapter aims at investigating the causes of changes in the value of money. Money resembles all other commodities because, like the latter, its value is also determined by demand and supply.

Demand and Supply of Money. By the demand of money is meant the total volume of business transactions which has to be done by money while the supply of money implies the total quantity of money unit available for use as a medium of exchange.

The Quantity Theory of Money. Expressed briefly, the theory may be enunciated as follows : Other things remaining equal, every increase in the quantity of money in circulation causes an exactly proportional increase in the general level of prices. This can be proved by a simple example. Supposing that there are 100 rupees and 100 commodities and assuming that all the commodities that are produced are bought and sold and that every unit of money circulates once only the average price per unit will be Re. 1. If instead of Rs. 100 there are Rs. 200 with which to purchase the same 100 commodities, the average price of each unit of commodity will be raised from Re. 1 to Rs. 2 (doubled) and the purchasing power of each unit of money will be reduced by half. The relation between the amount of money and the prices can also be explained with the help of an equation of exchange. If E represents the total expenditure in a given period of time and M the amount of money in circulation it is improbable that each unit of money would be circulated once only. It must have changed hands many times over to complete the number of transactions represented by E. The tendency of money to change hands repeatedly is called its velocity of circulation and can be calculated by dividing E by M. Thus

$$V = \frac{E}{M} \text{ or } E = MV$$

(Continued from previous page)

It may be noted, however, that there are many difficulties in the way of price stabilisation especially in view of the existence of a large number of price-levels viz., retail price-level, wholesale price-level etc. Statistics of retail prices are difficult to get and the quality of goods going under the same name keeps on changing from time to time. Moreover, it would not be possible to stabilise the prices of all commodities in which case the people will tend to invest money in articles whose prices are controlled in preference to commodities whose prices are exposed to constant fluctuations. A still more fundamental criticism is that a policy of stable prices would not guarantee the absence of inflation or deflation.

In view of these difficulties, Hayek, in his *Future of Monetary Policy and Prices and Production*, has advocated a policy of *Neutral Money, i.e.*, a system of money which will interfere as little as possible with the operation of non-monetary factors. According to him the ratios of exchange should be the same as under barter economy and the presence of money should not make any difference. In other words, money should be *neutral* in its effects on prices.

1 G.D.H. Cole—*What Everybody Wants to Know About Money*, p. 156 n.

Now, E represents the "goods side" and MV the "money side". E represents the total expenditure incurred on the commodities purchased and may be estimated by multiplying the price of each article purchased by its quantity or $E = pq + p_1q_1 + p_2q_2$ $p_3q_3 \ldots\ldots\ldots p_nq_n$. Substituting this in the above equation, we get

$$pq + p_1q_1 + p_2q_2 + p_3q_3 \ldots\ldots\ldots p_nq_n = MV$$

$$\text{or simply } \Sigma\ pq = MV \text{ or } PQ = MV.$$

But, since Q can also be represented by T, the total number of transactions;

$$PT = MV \text{ or } P = \frac{MV}{T}.$$

In this form the theory states that V and T being constant, P varies directly as M. In the modern world, however, bank money and its velocity of circulation are quite as important as M. Making allowance for them, the formula may be amended thus :—

$$P = \frac{MV + M_1V_1}{T}.$$

According to Fisher, M_1 bears a fixed relation to M with the result that if M changes M_1 also changes in the same ratio affecting P in the same proportion.

The exponents of the theory assert that M, M_1, V, V_1, and T are the only five factors affecting P and that other factors like changes in human wants, improvements in means of communication and transport, extension of banking facilities and changes in the monetary standard etc., only influence prices through the five factors mentioned on the right-hand side of the equation.

The quantity theory of money is proved by the past currency history of India although recently other influences have been more predominant in determining the level of prices than the quantity of money.

Objections. Among numerous objections, the most important ones are : (1) that the factors assumed to be constant are never constant ; (2) fall in the value of money is not always proportionate to the increase in its quantity ; (3) velocity of money cannot be easily determined ; (4) changes in M give rise not only to changes in P but also to changes in V and T, similarly changes in V, T and P are likely to be accompanied by changes in other factors ; (5) it does not offer a satisfactory explanation about the behaviour of prices during trade cycles.

Most of these objections will seem to lose weight if it is remembered that the theory is only applicable in the long run and under normal conditions only.

Other Theories. Recent economists have based their theories on a different interpretation of the term "demand for money".

The "Real-Balances Quantity" Equation. It was developed by Keynes in his *Tract*. Here the supply of money has been regarded as analogous to the supply of any other durable goods and the demand for money has been assumed to come from the willingness of the people to hold a certain amount of purchasing power in their hands. The theory that $n = p\ (k + rk')$ is more straightforward and more near practice. It does not make the questionable assumption of demand for money remaining constant when prices are changing. But the great defect in the theory is that the magnitudes of k and k′ cannot be easily measured statistically in actual life.

The "Cambridge" Equation. Associated with the names of Marshall and Pigou, it states that

$$p = \frac{M}{KR}.$$

There seems to be some similarity between this equation and that of Fisher but this is not so in reality. P and p are not the same things nor are R and T. It has been severely criticised by Keynes in his *Treatise*.

Quantity Theory and Trade Cycles. The Cambridge approach is better than that of Fisher so far as the explanation of trade-cycles is concerned because it emphasises that changes in price-level are not due to the changes in the supply of

money but to our habits regarding the holding of a proportion of our income in the form of money.

Saving and Investment Theory. It is based on the idea that trade cycles may be explained by the manner in which people save or spend their money incomes. It also shows that Trade Cycle is a causative factor and the price-level is the effect.

Rate of Interest and the Value of Money. Since savings and investment are themselves dependent on the rate of interest, it is only natural that the rate of interest should greatly influence the purchasing power of money. According to the latest theories developed by Wicksell and Keynes, if there is a divergence in the rate of interest prevailing in the market and the natural rate, the value of money (and the price-level) must change. Price-level and the value of money remain stable when the market rate and the natural rates of interest are equal. Keynes gives the following equation in this respect :—

$$P = \frac{E}{O} + \frac{I - S'}{R};$$

where E represents employer's cost for the consumers' goods, O represents output, I′ represents investment on producers' goods and S savings. When I′ becomes equal to S, the second part of the equation vanishes and the equation becomes $\frac{E}{O} = P$. But when there is a difference in I and S, that difference produces an effect on P in the same manner as E and O do.

Inflation—Its Causes and Effects. When the supply of money *relatively* to the demand increases to such an extent that the prices, in general, rise and the purchasing power of the monetary unit decreases the currency is said to be *inflated* and its purchasing power to be *depreciated*. It can be brought about either by increasing the volume of circulating media or by decreasing the volume of production. Inflation is *natural* if it is caused by the importation of precious metals or *artificial* if it is caused by an excessive issue of inconvertible notes (as during the War). It is harmful to the creditors and to the people earning fixed incomes. The agriculturist and manufacturers gain but only at the expense of the consumers and even their gain is temporary.

Deflation—Its Causes and Effects. If, on the other hand, the volume of currency is reduced in such a way that the prices fall, it is called *deflation*. Deflation may also be caused by a sudden increase in the volume of production—the amount of money in circulation remaining the same. When deflation occurs currency *appreciates*. Deflation is injurious to the producers and businessmen and confers a corresponding benefit on the wage-earners. Hence in a period of falling or rising prices conflict between the different sections of the community is inevitable. It is not high or low prices as such which do the harm but *rising or falling* prices. In the interest of social justice and harmony, therefore, steady prices are the best.

Reflation. If deflation has been carried out too far or too fast it may be necessary to raise prices up a little. This process of raising prices not resulting in inflation is called "reflation".

QUESTIONS

1. State and explain the Quantity Theory of Money and show under what circumstances it is possible for the price-level of commodities to remain the same even though there may be an increase or decrease in the amount of money in circulation ?

[Delhi Inter. 1930 and Agra B. A. 1933]

2. State in simple form the Quantity Theory of Money making clear the hypothesis under which it is true.

[Delhi B. A. 1934]

3. What, according to the Quantity Theory of Money, would be the effect on general prices of the following (other things supposed to remain the same) :—

(a) improvements in the means of communication ;

(b) the growth of trade and population ; and

(c) the development of deposit banking.

[Punjab B. A. 1923]

4. Explain the Quantity Theory of Money as propounded by Keynes. How does the theory mark an advance upon Fisher's exposition ? [Delhi M. A. 1948]

5. State what you understand by the term inflation. To what cause can it be ascribed and what consequences follow from it ? Illustrate your answer with examples from the recent currency history of this or any other country.

[Agra B. A. 1931 and Delhi Inter. 1933]

6. If inflation has occurred is it desirable that a policy of deflation should be adopted ? Give your reasons. What are likely to be the main effects of a policy of deflation ?

[Punjab B. A. 1926 and 1927].

7. How do changes in the value of money affect different classes of people in a country ?

[Agra B. A. 1932 and Calcutta B.A. 1928]

8. Are rising or falling prices the best ? Give reasons.

9. Discuss the use of

(a) dearness allowances ;

(b) consumers' subsidies ;

(c) raising rates of interest on Government loans ;

(d) decontrol ;

as methods of breaking the inflationary spiral.

[Delhi M. A. 1948]

CHAPTER VII

FOREIGN EXCHANGES

We have seen that if the inhabitants of a country owe money to each other, they can easily square up their accounts in the currency of their own country. The real difficulty begins when they start trading with foreigners who insist on payment being made to them either in their own currency or in the international currency, namely, gold. It is a matter of common knowledge that the currency medium of the present day no longer consists only of gold coins but of bank deposits and notes based on gold and these bank deposits and notes do not pass current in the different national areas. In the absence of a universally acceptable note or credit currency (such as only a unified international banking system can provide) the inhabitants of separate countries must naturally refuse to accept payment in other's notes or cheques or at best put different valuation on the money of the foreigners. The object of the present chapter, therefore, is to explain the complicated business of exchanging currencies' otherwise, called '*Foreign Exchanges*'. The volume of international transactions nowadays is so great that a slight variation in the value of money or a slight delay in payment usually causes considerable inconvenience and loss to the people engaged in trade and commerce. The subject is, therefore, well worth a detailed study.

Meaning of Foreign Exchange. Foreign Exchange may be defined as a system by which traders of different nations discharge their debts to one another. It is a branch of finance whereby the citizens of one country can acquire the means of making payments to the inhabitants of other countries and the term is usually confined to those payments which are affected by means of credit instruments and/or by the actual transmission of gold. Hartley Withers has defined it as "*the art and science of international money-changing.*"[1] On the art side it is concerned with the instruments of exchange and the institutions through which they are negotiated, and on the Science side it is a study of the rate of exchange and the numerous problems connected with it. To sum up, the expression "Foreign Exchange" is used to refer (1) to that class of written orders to pay money, legally known as bills of exchange, which are used so much oftener than money itself, as a means of making payments or settling indebtedness between distant places[2]; (2) to the price at which

1 Escher has defined it as "the business of buying and selling orders for the payment of foreign money at a foreign point."—*Foreign Exchange Explained,* p. 1.

2 Other methods of remitting money are :—

1. Export of gold ;

(Continued on next page)

these documents are exchanged or the rate of exchange ; and (3) to institutions (*e.g.*, banks, stock exchange, cotton exchange, etc.) through which these transactions are conducted.

Kinds of Bills of Exchange. Generally speaking there are two types of Bills of Exchange—the 'foreign' or 'outland' bills which are drawn in one country and payable in another and the 'inland' bills drawn and payable within the same country.

The Foreign Bill of Exchange. The foreign bill of exchange is the customary form of making international payments. It is defined by law as "an unconditional order in writing addressed by one person to another requiring the person to whom it is addressed to pay, on demand or at a fixed or determinable time, a sum certain in money to, or at the order of a specified person or to bearer." Its usual form is this :—

£100	*London 1st April, 1935.*
Sixty days after sight, pay to James Wilson or order, the sum of One Hundred Pounds. Value received.	
To	*A.B. Seller.*
C. D. Buyer, New York.	

In this example, A. B. Seller is the 'drawer', C. D. Buyer is the 'drawee' and James Wilson the 'payee' to whom £100 have to be paid by the drawee two months after the date of the bill.

The words "Sixty days[1] after sight" are particularly significant. They confer a valuable privilege upon the drawee. He may merely draw two parallel lines across the bill of exchange (B/E) and write "accepted" between them with his signatures to postpone his liability for actual payment till after the period allowed has expired. The bill thus '*accepted*' becomes a *Negotiable Instrument*. If the drawer or the holder of a bill cannot wait till then, he can sell it to a banker or the bill-broker for an amount less than the face value by the rate of interest for the period for which the bill is to run. The amount thus deducted is called '*discount*' and the process is called '*discounting*'. The banker or the bill-broker, if he stands in need of money, may have his once-discounted bill '*rediscounted*' at any other institution which is usually a Central Bank.

Kinds of Bills. Bills payable within ten days are called

(*Continued from previous page*)

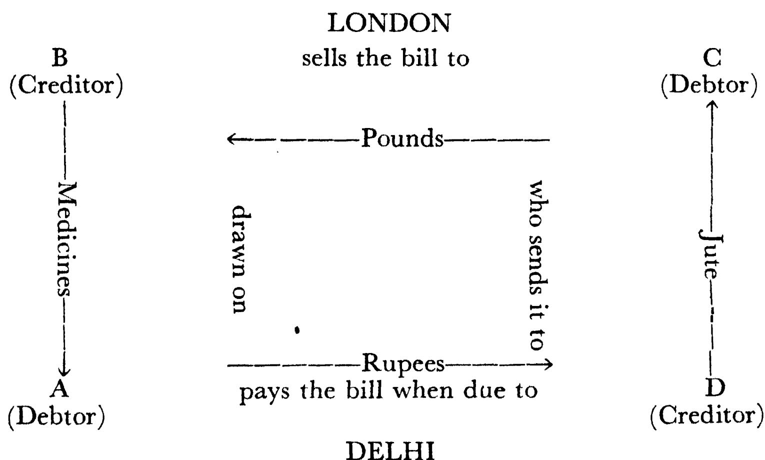
2. Bank Drafts in a foreign currency (*i.e.*, in the creditor's currency) ;
3. Bank Drafts in the home currency (*i.e.*, in the debtor's currency) ;
4. Interest coupons payable in a foreign country ;
5. The debtor himself drawing on a balance in a foreign bank.

See Richard—*Groundworks of Economics*, pp. 244-45.

1 It may also be 10 days, 30 days, 90 days or any other length of time.

"short bills"; those running for longer periods are known as "long bills". If the drawer grants no accommodation and insists on the bill being honoured on presentation, the bill of exchange is called a "sight bill". Bills payable some time hence are known as "usance" bills.

Working of a Bill of Exchange. To understand the working of exchange bills, let us assume that a merchant A in Delhi buys medicines from a merchant B in London and that another merchant C in London owes the *same amount* of money to a merchant D in Delhi in respect of jute imported by him. Now, B the English creditor, would not accept Indian rupees nor would D, the Indian creditor, accept pounds sterling. A and C, therefore, would both have to purchase gold and send it across the ocean in opposite directions and incur heavy cost of transportation and insurance into the bargain. To avoid all this trouble and expense, B the English creditor, draws a bill for the amount due to him which A the Indian debtor accepts. B has now the right to money in India. He sells his right to C the English debtor who wants to pay money in India. C sends the bill to D who, by means of his bank, collects the money from A. A simple diagram will show how this is done :—



Bank Drafts. Here we have assumed that the amount of money involved is the *same* but in actual practice this is hardly the case. Debtors have, therefore, to go to bankers and bill-brokers and obtain bills of the exact value which they have to remit. These bills of exchange *made to order* are called Bankers' Drafts. A bank draft is an order of one bank upon another to pay money to an individual, firm or corporation. Each bank makes a practice of keeping deposits with banks in other cities in order that they may be able to "draw" upon them.

Advantages of Bills of Exchange. The bills of exchange give the owner the right to receive a specified sum of money at a

given place and time and this right can be bought and sold. They provide a cheap and convenient way of paying international debts and enable merchants to be paid for their goods in the money of their own country. They help in economising the use of gold and in saving much expense and inconvenience which would become inevitable if foreign payments were made through the transmission of precious metals.

Inland Bills of Exchange—Hundis. This credit instrument usually employed for the payment of money within the same country is called a '*hundi*'. *Hundi* is a Persian word which literally means 'to collect'. Ordinarily, the word stands for all instruments of exchange drawn in vernacular. Dr. L. C. Jain defines a *hundi* as a "written order—usually unconditional—made by one person on another for the payment, on demand or after a specified time, of a certain sum of money to a person named therein."[1] It bears an impressed stamp and is usually drawn up in the vernacular '*Mahajani*'. The *muddati hundis* (deferred or usance bill) generally run for an odd number of days, that is, for 41 days in Banaras, Bombay, Lucknow, etc., for 61 days at Delhi, Farrukhabad etc., and for 121 days at Lahore and Multan. Some are drawn payable on the 11th or 21st day of issue. The sight bills are called *darshani hundis*. These documents start with salutations and words invoking divine blessings. The name of the payee and the amount (half and twice of which are also mentioned) are explicitly stated no less than five times in the actual body of the instrument. In the event of the first copy of the bill called "*khoka*" being lost a second copy or the '*penth*' or a third known as '*parapenth*' are drawn but in such a way as to avoid duplicate payment. The acceptance of a *hundi* is not entered on its face. Only the particulars of it are entered into the drawee's book. The rate of discount is known as '*hundiyana*'. It varies with the state of trade and the financial standing of the parties. The dishonouring of the *hundi* is very rare and every dispute arising out of the *hundi* transaction is immediately settled by the local panchayats of indigenous bankers.

Form of Hundi.[2]

SHRI GANESH JI SAHAI

Om Sri sada salamti hove. Messrs. Rawley Brothers Jog Likhi Lahore Seti Lala Ramchand Mool Chand di ram ram wachni. Aprant hundi nag ek tusade upper kitti. Rupya 1000 akhri ek hazar nimen rupaya. Rupya Panch Saw tis de dugne dewane. Kanak bheji tusade nam. Chet di das Samwat 1971. Din 60 pichche Shah Jog rupaya rokari chalan bazar chehra shahi bhar dewne. Chaukas ho kar dam dewne. Hundi miti Chet di das.

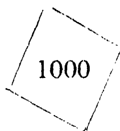
Daskhat RAM CHAND MOOL CHAND

1 *Indigenous Banking in India*, p. 71.

2 Reproduced from Thomas and Aggarwal—*Elements of Economics*, p. 397.

On the back of the note will be written :—

Rupaya ek hazar
nimen panch saw
tiske dugne
dewane.



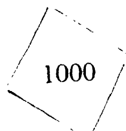
Messrs. Rawley Bros.
Export Agents,
KARACHI.

Put into English this reads something like the following :—May the blessed Ganesh protect. May you live in peace and happiness. Addressed to Messrs. Rawley Brothers from Lahore. Greetings from L. Ram Chand Mool Chand. Drafted this *hundi* against you for 1000 rupees (one thousand) half of which is 500. Pay double of that. Wheat despatched to your address this tenth of Chet Samwat 1971. Money must be paid after 60 days in the current coin of the realm of the Shah or a banker. Pay the amount after making enquiries and taking precautions according to the Bazar practice.

Hundi drafted on 10th Chet 1971.

(Sd.) RAM CHAND MOOL CHAND

Rupees one thousand,
half of which is five
hundred. Pay double
of that.



To
Messrs. Rawley Bros.
Export Agents,
KARACHI.

The Exchange Banks. The institutions through which foreign bills of exchange are bought and sold are called Exchange Banks. They have their branches in many commercial centres of the world and therefore they can give full facilities for the transfer of goods and money from one place to another. The exchange banks perform all the functions of an ordinary joint-stock bank[1] and, in addition, employ a large part of their funds in purchasing or discounting bills of exchange, particularly those drawn against export trade. These bills are of three kinds :—

1. Documents for acceptance (D.A.).
2. Documents for payment (D.P.).
3. Documents for delivery (D.D.).

The D.A. bills enable the importers to get the goods from the warehouse of the bank on their accepting the bill and the holders of the drafts have to rely exclusively upon the personal credit of the drawee and the acceptor until such time as the bills become due for payment—60 to 90 days hence plus the days of grace. The D.P. bills against which the documents will only be given up on payment, give better security to the holders and are drawn on ordinary merchants who cannot obtain accommodation from foreign exporters. The D.D's are rare. They confer an autho-

1 See Chapter on Banks and Banking.

rity to surrender the Bill of Lading[1] before acceptance takes place.

The Indian branches of exchange banks discount D.A. bills in India and when hard pressed for money they get them re-discounted in the London Money Market. They also transfer surplus funds to India for financing the foreign trade partly by selling sterling[2] to the Government of India and partly by shipping to India sovereigns and bullion in large amounts.

SUMMARY

Foreign Exchange. When people of a country trade with foreigners they must pay for their imports and receive payments for articles exported by them. There is thus a constant exchange of currencies and the study of the various aspects of this international money-changing is called Foreign Exchange. In this chapter only documents of exchange and the institutions through which they are negotiated are discussed.

Kinds of Bills of Exchange. The most important instrument of exchange is the Bill of Exchange. It is of two kinds—the 'foreign' or 'outward' bill which is drawn in one country and payable in another and the 'inland' bill drawn and payable within the same country.

The Foreign Bill of Exchange. It is a written request or an order from the drawer to the drawee to pay a certain sum of money either to himself or to some other man stated in the bill (and called the payee) on demand or some time hence. Bills payable on presentation are called 'sight' bills. Those which are payable after some time are called short or long bills according as they are payable within ten days or later respectively. The 'long' and 'short' bills are presented to the drawees who 'accept' them by drawing two parallel lines across the face and writing the words 'accepted' with signatures in between. After being 'accepted' a bill becomes a 'negotiable instrument'. It may be held till maturity or if the then holder of the bill is urgently in need of money he may sell it to a bank in which case he will get the face value of the bill minus the interest for the period the bill is to run. This deduction made by the bank is called 'discount' and the process is called 'discounting'. In case the bank purchasing this bill stands in need of money, it can have it discounted once again at the Central Bank—the process being called 're-discounting'.

The Working of a Bill of Exchange. The working is simple. In every country there are importers (debtors) and exporters (creditors). The creditors of one country draw bills on their debtors in other countries and have them duly accepted by them. These bills they sell to the debtors of their own country who desire to send money abroad. The debtors (importers) send these bills to their creditors in other countries who collect them from the debtors of their own country (who had originally accepted the bills). In actual practice, the amounts of bills may differ and the importers (debtors) may not be able to find the creditors who may be willing to sell them their bills. Hence all bills are purchased through bankers and bill brokers who draw bills of the exact value one wants to remit. These bills of exchange made to order are called Bankers' Drafts.

The bill of exchange is a *cheap* and *convenient* method of remitting money. *A single bill cancels two transactions and enables people to be paid in the currency of their own country.*

Inland Bills of Exchange—Hundis. A hundi is an indigenous instrument of remitting money. It is usually drawn up in *Mahajani*. The *mudatti hundis* (usance bills) often run for odd number of days and can be discounted and re-discounted like foreign bills of exchange—the deduction in this case being called *hundiyana*. The sight bills are called *darshani hundis*. Unlike foreign bills of ex-

1 It is a memorandum of goods shipped on board a vessel signed by way of receipt by the master of the vessel.

2 See Chapter VIII.

change a *hundi* begins with salutations and words invoking Divine blessings. The name of the payee and the amount (half and twice of which are also stated) are mentioned no less than five times in the body of the bill. A *hundi* is seldom dishonoured and all disputes arising out of *hundi* transactions are settled by the local panchayats of indigenous bankers.

A specimen of a *Mudatti Hundi* is given.

The Exchange Banks. These banks perform all the functions of an ordinary bank and, in addition, deal in (purchase, sell, discount, and re-discount) foreign bills of exchange which are of three kinds—D.A's (or Documents against Acceptance) which enable the importers to get the goods from the banks merely on accepting them ; D.P's (Documents against Payment) which insist on payment being made before the delivery of goods is made and D.D's (Documents against Delivery) which confer an authority to deliver goods before acceptance takes place.

QUESTIONS

1. What is meant by Foreign Exchange ? [Delhi Inter. 1929]

2. What is a foreign bill of exchange ? When is it said to be discounted ?

Show how by means of a bill of exchange a sale of goods to a merchant in London and a sale to a merchant in Delhi by a merchant in London may be liquidated without sending specie from one country to another.

[Agra B. A. 1934 ; Delhi Inter. 1928 and 1930]

3. State what you know about Hundi. Give a specimen form of a Hundi used in your locality and explain its meaning as clearly as you can.

[U. P. Inter. 1930]

4. Describe the part played by the Hundi in the banking and the commercial systems of India and compare it with the corresponding instruments of credit in other countries. [Punjab B. A. 1931]

CHAPTER VIII

FOREIGN EXCHANGE—*(Contd)*.

THE RATE OF EXCHANGE

Having studied the objects and functioning of exchange instruments and institutions, it remains for us to explain how the price of the bills of exchange is determined. In other words, we have to study the methods of determining the rates of exchange between different countries and the causes affecting their fluctuations from time to time.

Definition of the Rate of Exchange. The rate of exchange between two countries is the price paid in the home countries for one unit of the money of the foreign country payable in that country or more simply, "the price of the money of one country expressed in the money of the other."[1] It is generally quoted in two ways :—

1. One unit of the foreign currency to so many units of the home currency, or

2. A certain number of units of foreign currency to one unit of home currency.

Thus we can say £1=Rs. 15 or Re.1 $=\frac{1}{15}$£1, *i.e.* 1s. 4d.

Methods of Determining the Rate of Exchange. Since different countries of the world have different money standards,[2] it is but natural that the rates of exchange between them should be fixed by different considerations. For the sake of simplicity, let us classify them in four categories.

The *first* category includes all countries on the gold standard. Their principal currency consists of gold coins of different size and denominations and the rate of exchange between them is determined by finding out how many coins of one country can be made out of the metal contained in *one* coin of the other country. This method of ascertaining the rate of exchange by comparing the metallic contents of the currencies of different countries is called the Mint Par Theory of Exchange. A simple example will make it very clear. Suppose we want to find out the rate of exchange between England and America—*assuming both of them to be on the gold standard.*

Now, we know that the weight of the British Sovereign (£) ···
=113·0016 grains of fine gold.

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1 Escher—*Foreign Exchange Explained,* p. 1.

2 See Chapter IX.

But because the weight of the American golden eagle which is equal to 10 dollars ($ 10) = 232·2 grains of fine gold,

The weight of one dollar ($ 1) = 232·2 grains of fine gold.

Therefore, £1 $= \frac{113·0016}{23·22} =$ ($4·8665.)

Hence the London—New York or Sterling—Dollar Mint Par of Exchange is 4·8665 (£1 = $4·8665)[1].

Similarly, the mint par of exchange between English and German currencies can be deduced as follows :

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1 It should be noted that the same method would also apply to two countries on the silver standard if the price of silver is the same all over as well as to those one of which has a gold standard and the other a silver standard provided the value of silver in respect of gold remains fixed. We can also find out the *theoretical* mint par of exchange between two countries—one of which possesses a gold standard and the other gold exchange standard provided the metallic contents of the latter currency are known. For example, the rate of exchange between England (assuming it to be on the gold standard) and India is calculated thus :—

The rupee contains 165 grains of fine silver or $\frac{165}{480} = \frac{11}{32}$ ounce.

But 37 ounces of fine silver = 40 ounces of standard silver.

∴ the amount of standard silver contained in the

rupee $= \frac{11}{32} \times \frac{40}{37} = \frac{55}{148}$ ounces.

Now, if the price of standard silver be assumed to be 43d. per ounce,

the value of silver contained in the rupee will be $= \frac{55}{148} \times 43 = 16$d.

But if the price of silver is 48d. per standard ounce, the price of silver contained in the rupee will be $= \frac{55}{148} \times 48 = 18$d.

Thus, now that the exchange between India and England is Re. 1 = 18d. the melting point of the rupee would be reached as soon as the price of silver rises to 48d. per standard ounce. In other words, if exchange between India and England is left free and if the price of silver in the market is 48d. per ounce, the rate of exchange would be Re. 1 = 18d.

Also note that the rupee issued during the war period contains only 90 grains of silver. It will be profitable to melt this rupee if the price of silver reaches about 89d. per ounce.

90 grains of fine silver $= \frac{90}{480} = \frac{3}{16}$ ounces ;

or $\frac{3}{16} \times \frac{40}{37} = \frac{15}{74}$ ounces of standard silver.

Assuming the rate of exchange to be 18d.

$\frac{15}{74} \times X = 18$d. where X = melting point

X = 88·8d.

X marks	$=£1$
£1	$=240$d.
934·5d.	$=1$ ounce standard gold
12 ounces standard gold	$=11$ ounces fine of gold
1 ounce fine gold	$=31·103496$ grains of fine gold
1000 grains fine gold	$=2790$ marks

$$\therefore\ X = \frac{240 \times 11 \times 31{\cdot}103496 \times 2790}{934{\cdot}5 \times 12 \times 1000}$$

$$= 20{\cdot}42945 \text{ marks.}$$

Thus every 20·43 marks of German gold money contain just so much gold as would be required to coin £1 sterling, or £1=R.M.[1] 20.43.

By similar comparisons the Mint Pars between any two countries using the same metal as their standard of value can be calculated but it must be understood that any Mint Par is merely a theoretical measurement of the value of one standard coin in terms of another standard coin. It takes no account of practical variations in the weight or fineness of actual coins due to wear and tear and is a purely arbitrary basis of comparison. It may not be possible to obtain gold coins in either country and the free import or export of gold may not be permitted so that actual transference of coins would be impossible but as long as the existing coinage laws of the two countries remain unchanged the Mint Par between them will also remain unaltered as it is a theoretical rate of exchange based on the laws themselves.

Even when gold is available, the traders prefer to settle their debts through exchange bills purchased from bankers and brokers. If the bills drawn on a particular country are exactly equal to the bills drawn by this country upon foreigners, there is no difficulty. The debts are offset by credits. Such a condition, however, seldom exists. In actual practice, sometimes a country imports more than what it exports and sometimes its exports largely exceed its imports, so that the price of the bills of exchange varies in accordance with their supply and demand. Let us take a concrete example to show how it all happens. A in New York (America) has sold a consignment of steel to E in London (England). Before its being despatched from New York the steel becomes represented by a Bill of Lading on the strength of which A can get payment from a bank even before its arrival in London. A draws a bill of exchange upon E for the amount, that is, he instructs E to pay a definite sum at a definite time. It may be, according to the terms of the bargain, payable 'at sight' or in three months. This bill of exchange and the Bill of Lading are sold by A to a New York banker who sends them to his London agent from whom E obtains the Bill of Lading—enabling him to get the steel—by accepting or by actually paying

1 R.M. = Reichmarks.

the bill (depending upon whether the bill was a D.A. or a D.P.). The New York banker thus has at his disposal credit in London.

Now, suppose another businessman L in U.S.A. owes money to somebody in England. He goes to the New York banker (who has credit in London) and wants a draft payable in London. The banker knows very well that if his client did not get the bill he shall have to ship the required amount of gold and incur the cost of transportation and insurance into the bargain, that is, in addition to spending $4·866 for every £1, he will have to spend ·024 cents per sovereign. He, therefore, quotes for his bill any price between $4·866 and $4·89 (4·866+·024). He cannot demand a price higher than $4·89 (for every £1) because, otherwise, L, the American debtor, will think it worth his while to undergo the risk and expense of shipping gold. The highest point to which the price of bills can go is called the *Upper Specie Point.* It is found by adding the cost of insurance and freight to the mint par. It may also be called the 'outward,' or 'export gold point' because beyond this limit, so far as the American is concerned, gold will be exported.

It should be remembered that the price of the bill will seldom be exactly $4·89. It will vary between $4·866 and $4·89 depending upon the supply and demand of bills.

Now, imagine that there is a little or no demand for bills on London in America. What should the New York banker do to transfer the money lying to his account in London, to America ? He will have to have it converted into gold and shipped to New York in which case, after *deducting* the cost of transportation and insurance, he will get $4·842 (4·886 *minus* ·024 cents) for every pound deposited to his account in London. This is the maximum that he can get. So he will try to persuade some stray American debtor to purchase a bill from him and offer to charge from him a price even *less* than the mint par but not less than $4·842. Thus we find that *if the demand for these bills of exchange is less than their supply,* their prices fall. The lowest price to which it can fall is determined by subtracting the cost of commission, insurance and freight from the mint par and is called the '*Lower Specie Point*'. From the point of view of the Americans, it may be regarded as the "inward" or "import" gold point because if the price exceeds this limit gold will certainly be imported into the U.S.A.

To sum up, the rate of exchange between two countries on the gold standard is determined by the Mint Par and the rate thus determined fluctuates between the upper and lower specie points depending upon the extent and mutual indebtedness measured by the supply and demand of bills.

In the *second* category we put two countries one of which is on a gold standard and the other on an inconvertible paper currency standard. This case is slightly complicated owing to the inability of the country on the paper standard to discharge its obligations in gold. The people of such a country will have to depend *entirely*

upon the bills of exchange and the holders of such bills (bankers and bill-brokers) will take full advantage of their helplessness. They will not be bound by the specie points : in fact if the demand for foreign remittance is very keen they will charge a price much higher than the upper specie point. In the previous example if the American debtors did not have the alternative of sending gold to London, the New York banker would have charged from them much more than $4·89—say, $5 or even $6 (for every £1 to be remitted to London) if the demand for his bills was really intense. The other country—on the gold standard—however, will not be affected because so long as the people have the option of sending gold abroad the rate of exchange will be prevented from deviating from the par by more than the cost of transportation and insurance.

The *third* category is typical of war conditions. It comprises all countries on inconvertible paper currency standards. Here neither country enjoys the privilege of sending gold to and fro. The holders of bills of exchange are, therefore, in an excellent position to charge whatever price they think reasonable for their bills. They demand higher prices when the demand is great than when the demand is small and very often these prices overstep the limits set by the specie points.

The Balance of Trade Theory. It is thus clear that the price of exchange bills depends upon their number and since they are created in response to the requirements of trade, the rate of exchange may safely be held to be determined by trade conditions. If a country exports more than what it imports, the balance of trade is in its favour. It has a greater claim upon the currency of other countries than those countries have upon its own. The money of this country will, therefore, be at a *premium*, that is, it would command greater value in respect of the currency of the other country and the rate of exchange will be clearly *favourable*[1] to it. Conversely, if the balance of trade is unfavourable to a country its currency in respect of the currency of another country will be at a *discount*, that is, it will command less exchange value and the rate of exchange will be against it. This is the famous Balance of Trade Theory.

The Balance of Accounts. It will be noticed that we have all along assumed that payments are made for *goods* only but in modern times there are innumerable other transactions among trading nations *which are not recorded* but for which payments must be made.[2] A true *balance of accounts* between them should be struck by including all the *total credits and debits*, that is, all aggregate visible as well as invisible imports and exports.

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1 For a clear conception of favourable and unfavourable exchanges read *The Foreign Exchange Market* by F. R. Miller, pp. 45-46.

2 " There are," says Hartly Withers, " many more exports in heaven and earth than are dreamt of by the philosophy of the Board of Trade."—*The Meaning of Money*—p. 190.

Visible and Invisible Imports and Exports. By *visible* imports and exports we mean those goods and bullion for whose movement from one country to the other proper statistics are kept. The terms *invisible* imports and exports refer to those items of which *no records are kept*—the former is applied to such unrecorded items for which a country has to pay and the latter to those which entitle her to receive payment. Some of the items that should be included in a country's balance sheet are :—

1. *Foreign trade of the country* including trade in merchandise and treasure. A country is a debtor to the extent of its imports but has to be paid for its exports.
2. *Loans* offered or received from abroad. While a loan is being carried out the nation contracting the debt is the creditor and the nation which advances the loan is the debtor. The position is, however, reversed at the time of the payment of the interest or the repayment of the principal.
3. *The earnings of the nationals* of a country doing business abroad, so far as they are remitted to the mother country, count towards the credit side of that country.
4. *The remittance of money for benevolent purposes.* The country receiving the charity becomes a creditor while the country sending the donation becomes a debtor.
5. *The expenditure of a nation's government abroad* will make it a debtor to that extent and, conversely, the expenditure of other governments in a country will make it so far a creditor.
6. *The payments of tributes or indemnities* obviously makes the paying country a debtor and the receiving country a creditor.
7. *The expenses of students and tourists* residing or travelling abroad make their country indebted to that extent.[1]

The Balance of Trade of India. The following table gives an idea of the visible balance of accounts of India during the three years (1934-37) as well as the average of ten years immediately preceding the War. For the sake of simplicity, figures have been expressed in crores of rupees and amounts less than 1 lakh of rupees have been omitted.

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1 " In a foreign exchange market, demand (for money) arises not only from the importation of goods, services or securities, but also from the service of political and other debts, from desire to speculate in foreign currencies, from desire to travel, from the purchase of lands, houses and factories abroad, from long and short loans to foreigners, from presents and other remittances and from a desire to export one's capital. Similarly, supply results not only from actual export of goods but also from the sale of securities, from the sale of financial, shipping and personal services, from dividends earned abroad, from short and long term borrowings and from speculative purchase of currencies by foreigners (for a rise or for safety)" *The Problem of Foreign Exchanges.*—L. L. B. Angas, p. 18.

BALANCE OF TRADE OF INDIA

Item	Pre-war	(In crores of rupees) 1934-35	1935-36	1936-37
Export of Indian merchandise (private)	+ 2,19	+1,52	+1,61	+1,96
Re-exports of foreign merchandise (private)	+ 5	+ 4	+ 4	+ 4
Imports of foreign merchandise (private)	— 1,46	—1,32	—134	—125
BALANCE OF TRADE IN MERCHANDISE (PRIVATE)	+ 78	+ 23	+ 31	+ 78
Gold (private)	— 29	+ 53	+ 37	+ 28
Balance of transactions in treasure (private)	— 36	+ 53	+ 37	+ 15
Total visible balance of trade ...	+ 42	+ 76	+ 67	+ 92

Item	Average of 10 pre-war years	(In crores of rupees) 1934-35	1935-36	1936-37
Purchase of sterling by the Reserve Bank of India ...	—41	—50	—49	— 71
Sale of sterling by the Reserve Bank of India	—	—	—	—
Transfers of Government securities				
Interest Drafts on India in respect of Government of India securities	—	—	—	—
	—	—	—	—
BALANCE OF REMITTANCE OF FUNDS ...	—43	—50	—46	— 71
TOTAL VISIBLE BALANCE OF ACCOUNT (PAYMENTS)	—	+26	+20	+ 21

The table shows that the visible balance of trade, as measured by statistics of private merchandise and treasure in 1937 was about Rs. 92 crores as compared with Rs. 67 crores in 1935-36. The improvement of Rs. 25 crores was the combined result of an increase of Rs. 35 crores in exports of Indian merchandise and a decline of Rs. 10 crores in the imports of foreign merchandise. There was also a fall of Rs. 9 crores in the export of gold.

The net balance of remittance of funds came to about Rs. 71 crores and the total visible balance of accounts for 1937 was about Rs. 21 crores, *i.e.*, only one crore more than in the preceding year but five crores less than in 1934-35. The figures relating to remittances include the more important Government transactions but do not take into account (*a*) net payments in India of British postal

orders and of foreign money orders of countries which settle their accounts through London, and (*b*) Government transfer on account of Iraq and Mauritius.

The balance of account shown in this statement is not actually a complete record of the state of affairs as there are many items for which no statistics are available and the volume of which it is not possible to estimate, such as remittances for domestic expenditure in England, investments abroad etc. on one side of the account and remittance for investment in India, expenses of tourists, etc. on the other. The statement, therefore, contains only those factors for which Government statistics are available. The League of Nations has, however, attempted to estimate the total credits and debits (including goods, services and gold) of the member countries. The table on the next page gives an idea of the estimated balance of payments of British India for 1930-33.[1]

It will also be noticed that although India had a favourable balance of trade, she had an unfavourable balance of payment. That is so because India had to pay huge amounts to foreign countries, particularly England, for various commercial and other services rendered to her. India's balance of payments consists of exports of merchandise and treasure, loans raised in foreign countries, remittances from foreigners and the money spent by foreign tourists on the credit side, and imports of merchandise and treasure, interest on foreign loans, repayments of loans, remittances from India to foreign countries, profits of British banks and insurance companies, freight charges paid to British shipping companies, expenses of Indian students and tourists abroad, and "Home Charges" on the debit side. The "Home Charges" were an annual payment made by India to England in respect of (1) interest on loans raised in England to finance railway and irrigation schemes, (2) Government stores charged against revenue, (3) leave and furlough allowances, pensions and gratuities of all kinds, (4) the cost of maintaining the High Commissioner for India in London and of the India Office, and (5) the military and marine charges. Thus a large sum of money went out of the country either as interest and profit accruing on foreign investments in India or towards the expenses incurred by the Secretary of State on behalf of the Government of India in England and was sometimes called a "drain." Considering, however, the valuable services rendered by foreign capital in developing Indian trade and industries at a time when Indian capital was being recklessly hoarded the whole of the foreign capital invested in the country could not be regarded as harmful. Exception could, however, be taken to that part of the foreign capital invested in India which tends to increase the strength of vested interests in this country or which led to the speedy exhaustion of her natural resources. The amount of "Home Charges" could also be substantially reduced by Indianising the Army and the Civil

1 *Balance of Payments*—pp. 113-15.

Items.	(Rs. (00000s)) Inward or credit movements (exports)				Outward or debit movements (imports)			
	1929-30	1930-31	1931-32	1932-33	1929-30	1930-31	1931-32	1932-33
I. Merchandise.								
1. Merchandise ...	3,204·6	2,282·8	1,630·4	1,372·1	2,630·3	1,865·5	1,350·3	1,366·5
2. Adjustments on account of :—								
(*a*) Land frontier trade ...	200·0	160·0	160·0	99·0	180·0	160·0	100·0	80·0
(*b*) Wrong valuation ...	...	...	...	...	56·2	56·0	67·3	68·5
II. Interest and dividends.								
3. Interest and dividend on long-term capital ...	30·8	21·6	9·7	6·3	} 359·0	359·0	360·1	353·0
4. Interest on short-term capital ...	12.2	1·6	2·8	2·6				
III. Other Services.								
5. Shipping freight ...	...	...	...	...	...	...	...	...
6. Port fees ...	28·0	25·0	24·0	22·5	...	...	...	...
7. Commission, insurance brokerage ...	...	...	...	...	12.0	12·0	10·0	10·0
8. Post, telegraph and telephone ...	1·4	1·2	...	...	0·9	0·9	1·0	1·2
9. Tourists, diplomatic expenditure, etc. ...	...	...	...	...	45·0	45·0	40·0	40·2
10. Reparations in cash ...	3·3	3·2	0·8	...	...	...	...	...
11. Other Government receipts and expenditure ...	114·6	85·0	90·8	88·3	269·5	215·6	244·0	221·0
IV. Gold.								
12. Gold coin and bullion ...	0·1	4·9	607·7	668·4	142·3	132·5	28·0	13·2
Total ...	3,595·0	2,585·3	2,476·2	2,248·2	2,695·2	2,836·3	2,200·9	2,153·4

Services and by purchasing stores in India and not in England. World War II has been a great blessing to India in this respect. Owing to very heavy trade balances in her favour, India has not only cleared off most of her foreign indebtedness but has also amassed a large amount of sterling balances in England. These balances will undoubtedly help her to buy goods and services after the war and obviate the necessity of exporting goods and treasure out of the country.

India's Balance of Payments Today.

The figures quoted above, although only illustrative, have become rather old. The composition and direction of India's foreign trade have undergone much change since World War II. The methods of recording transactions have also greatly changed in recent years. The following figures will, therefore, be found to be both interesting and instructive :—

TABLE I

INDIA'S BALANCE OF PAYMENTS

(January—December, 1949) [In crores of Rs.]

Item	Receipts (+)	Payments (−)	Net
1. Merchandise[1] ...	419·1	602·3	−183·2
2. Non-monetary gold movement ...	...	...	...
3. Foreign travel ...	...	4·2	−4·2
4. Transportation[2] ...	24·8	7·5	+17·3
5. Insurance ...	4·6	2·4	+2·2
6. Investment Income ...	11·0	27·2	−16·2
7. Govt.—Not included elsewhere ...	33·8	49·1	−15·3
8. Miscellaneous[3] ...	33·7	20·2	+13·5
9. Donations[4] ...	16·5	5·1	+11·4
9A. Unclassified ...	21·8	6·1	+15·7
10. Total Current Transactions	565·2	724·1	−158·9

It will be seen that the payments deficit for the year 1949 was Rs. 158.9 crores. Considering that the amount of deficit in the preceding year was only Rs. 83 crores, this figure was quite high. The sterling, hard currency and "other areas" accounted for a deficit of Rs. 51·3 crores, Rs. 41 crores and Rs. 66·6 crores respectively.

1 Excludes transactions under Government barter deals.

2 Covers on the receipt side, estimated amount for re-imbursement of freight paid in advance by exporters and disbursement of foreign ships in Indian ports etc., and on the payments side, operating expenses abroad of Indian steamship companies and some freight payments.

3 Covers mainly receipts and payments for services such as those for education, film rentals, agency services and maintenance of estates.

4 Comprises unilateral transfers like maintenance allowance and receipts of missionaries etc.

TABLE II

INDIA'S BALANCE OF TRADE (1949)

Region-wise [in crores of Rs.]

	Sterling Areas			Hard Currency Areas			Other Areas		
	+	—	Net	+	—	Net	+	—	Net
1. Merchandise									
(a) Private	228·2	223·6	+4·6	119·8	108·4	+11·4	70·6	99·1	—28·5
(b) Government food and other stores	0·2	94·5	—94·3	0·4	53·0	—52·6	...	35·7	—35·7
2. Gold (non-monetary)	...	...	...	...	...	...	...	...	...
3. Services									
(a) Foreign travel, transportation and insurance.	20·5	11·4	+9·1	4·5	2·7	+1·8	4·3	...	+4·3
(b) Investment income	11·0	20·8	—9·8	...	6·4	—6·4	...	...	...
(c) Govt. transactions (not included elsewhere.)	28·5	33·3	—4·8	5·3	3·1	+2·2	...	0·8	—0·8
(d) Miscellaneous	28·6	6·4	+22·2	4·4	3·3	+1·1	0·7	10.4	—9·7
4. Donations	12·9	4·5	+8·4	3·4	0·5	+2·9	0·2	...	+0·2
5. Unclassified	17·3	4·1	+13·2	0·7	2·0	—1·3	3·8	...	+3·8
Total	347·0	398·6	—51·3	138·5	179·5	—41·0	79·5	146·1	—66·6

Exports Pay for Imports. Taking the exports and imports in the broad sense, we may say that the exports pay for imports for, in the *long run*, no country can afford to import more than what it exports or export more than what it imports. In other words, if something of value is bought from foreigners something of equal value has got to be sold to them. The money value of exports and imports must ultimately balance. "If an Englishman buys an American car instead of a British one American dollars will sooner or later have to be bought to pay the American manufacturers. Pounds, in fact, will be spent on dollars. The American manufacturer might, it is true, temporarily accept payment in pounds but eventually he himself will want to convert these pounds into dollars. Thus there will arise sooner or later the problem of finding someone who will part with dollars in exchange for pounds, that is, spend dollars on pounds. But the only person who will permanently spend dollars on pounds is someone who wants to buy British goods *i.e.*, to import from Great Britain. Indeed, in the long run, any pounds initially spent on dollars (for example, to buy imported American cars) must sooner or later be re-spent on British exports. Eventually in fact exports must equate in sterling value with English imports."[1] Normally exchange of goods for goods or services takes place and the balance is adjusted through the remittance of specie. The paying out of specie or receiving it affects the supply of money and produces such changes in prices as lead to the equalising of

1 *The Problems of the Foreign Exchanges*—pp. 18-19.

imports and exports. If, for example, trade is on the whole favourable to America, it stands to reason that prices in the U.S.A. are comparatively low ; that it is a good country to buy from and a bad country to sell to. Consequently, money will flow into America and by raising prices remove the very cause that had made America a creditor country. The whole position has been beautifully summed up by Gide thus : "There is a sort of automatism in the balance of accounts that tends to restore the equilibrium whenever it is disturbed—in much the same manner that regulators on steam engines tend always to maintain a uniform speed. The current of trade cannot for ever continue in one direction any more than the tide of the sea ; sooner or later it must change and after metallic money has been taken out of a country there are natural forces which tend to bring it back again."[1]

It must also be borne in mind that the terms imports or exports are used in their wide sense to embrace *all* visible as well as invisible items going to and coming from *all* other countries to the country whose balance-sheet we want to strike. Moreover, the balance of trade is never settled within any period of twelve months like that of the official year which is usually made the basis of our calculations but if longer periods are taken the adjustment will be seen to have taken place.

To avoid further digression, let us recall the main point of our present discussion, namely, that according to the balance of trade theory, the rates of exchange between countries on inconvertible paper currency standards fluctuate according to the state of mutual indebtedness which we have called the balance of accounts.

There is, however, an alternative explanation which, since the First World War, has assumed much greater importance. According to this view *inflation* is the principal cause of changes in the rate of exchange. Since this theory is based on difference in purchasing power caused by inflation in different countries, it has been called the Purchasing Power Parity Theory.

The Purchasing Power Parity Theory. If there are two countries on a gold basis and the unit of currency in each of them contains 10 grams of gold, then one unit of the currency of one will be equal to one unit of that of the other or the par of exchange will be unity. If both of them resort to inconvertible paper money and the former doubles the quantity of currency in circulation, while the latter quadruples it, the price level in the former will be half of that of the latter. The rate of exchange, therefore, will be 1 : 2 in accordance with their price-levels. The rate of exchange obtained by comparing price-levels of two countries is called the purchasing power parity.

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1 *Principles of Political Economy,* p. 300.

The essence of this theory[1] is that we judge the value of a foreign currency to us by its command over goods and services. Purchasing power is indicated by the general level of prices so that if prices in a foreign country are higher compared with our own, the money of that country will not go very far and we, therefore, expect to get more of its money in exchange for our own. In other words, the value of the unit of one currency in terms of another is, in the long run, determined by the relative values of the two currencies indicated by their relative purchasing powers over goods and services.

Take, for example, the rupee-sterling exchange. Assuming that goods pass freely between India and England and that exchange is not artificially regulated, the rate of exchange between them, when the index numer of prices in either country is 100, is Re. 1 = 18d. If, however, as a result of inflation, prices in England rise from 100 to 150 the purchasing power of the English currency falls relatively to the rupee which will now be equivalent to $\frac{18 \times 150}{100}$ = 27d. If, on the other hand, Indian prices also rise, say from 100 to 200, the purchasing power of the rupee having fallen more compared to the depreciation of the sterling the new rate of exchange $\left(\frac{18 \times 150}{200} = 13\frac{1}{2}\text{d.}\right)$ will be more favourable to England.

Hence, "the purchasing power parity between any two currencies is obtained by multiplying the current index number of prices in the country in whose currency the figure is to be expressed by the pre-War par of exchange in order to make the two index numbers of prices comparable and dividing this result by the current index number of the second country."[2] This may also be reduced, for our present purposes, to the formula

$$\frac{\text{British Index Number} \times 18\text{d.}}{\text{Indian Index Number}}.$$

The equation can be approximately verified by taking actual figures. The rate of exchange before World War I was Re. 1 = 16d. During the War when England created immense purchasing power by issuing inconvertible currency, prices went up from the pre-War par of 100 to 226 while in India the price-level rose from 100 in 1914 to 178 in 1919 with the result that the new rate of exchange

1 Cassel, the founder of the theory, has explained it thus : "When two currencies in two countries have heen inflated the new normal rate of exchange will be equal to the old rate multiplied by the quotient between the degrees of inflation of both countries. There will, of course, always be fluctuations from these normal rates and, in a period of transition, these fluctuations are apt to be rather wide. But the rate calculated in the way indicated must be regarded as the new parity (or par of exchange) between the currencies. This parity may be called the Purchasing Power Parity as it is determined by the quotient of the purchasing powers of different currencies."—*The World's Monetary Problems.*

2 Chablani—*Indian Currency, Banking and Exchange*, p. 58 (Ed. 1932).

(Re. 1 = 20d.) corresponded with the new rate calculated by the purchasing power parity theory, *viz.*,

$$\frac{226 \times 16}{178} = 20{\cdot}3\text{d.}$$

The Babington Smith Committee recommended the extraordinary rate of 2 shillings mainly on the ground that prices in India were considerably lower than prices outside. Similarly, the Hilton Young Commission recommended 18d. rate because the prices in India *at that rate* were equal to the world prices. The knowledge of the purchasing power parity was thus put to great advantage in solving some vital problems of Indian currency and exchange.

Limitations of the Purchasing Power Parity Theory. It should be remembered that calculation of the purchasing power parity depends upon index numbers of prices. Since index numbers are merely indications of *average* rise or fall of prices, the rate of exchange calculated by means of the purchasing power parity theory frequently deviate from the existing rates of exchange as the table below will show :—

I Date		II English Index Number.	III American Index Number.	IV Existing Exchange Par—£1—$4.86	V Exchange determined by Purchasing Power Parity.	VI Percentage deviation of Purchasing Par from existing parity. Ratio of IV & V
June,	1932	97·4	86·4	3·67	4·32	17·7
September,	1932	106·0	91·2	3·44	4·18	21·5
January,	1933	91·5	87·4	3·45	4·65	34·7
June,	1933	95·6	93·1	4·11	4·74	15·4
January,	1934	97·1	103·4	5·09	5·18	1·7
May,	1934	95·4	105·6	5·11	5·39	5·4
June,	1934	94·9	106·9	5·04	5·48	8·7
September,	1934	96·6	111·2	5·00	5·60	12·0
December,	1934	97·4	119·2	4·94	5·51	11·5
January,	1935	98·4	112·0	4·91	5·58	13·6
March,	1935	97·5	113·2	4·77	5·65	13·4

Here it is assumed that the exchange rate of the base year is a true equilibrium rate. This is unlikely to be true in a strict sense and the error may be a very considerable one.

To obtain correct results, therefore, great care has to be taken in the construction of index members especially in the matter of selecting a suitable basic year[1] and in the collection of accurate figures of wholesale prices of representative articles. Sometimes the violent movements of exchange rates obstruct trade and prevent goods from finding their

1 Cassel hss suggested 1913 as the best.

true level of prices. Sometimes speculation and anticipated inflation exert such a great influence on the exchange market that the actual rate prevailing at the time is very different from the one calculated by means of the purchasing power parity theory. For example, if inflation is expected in England, people may remove money balances from London and numerous pounds may be exchanged for francs. The extra supply of pounds and demand for francs thus engendered may temporarily depress the rate well below the true purchasing power parity. Deviation of the purchasing power parity from the existing rate will be particularly great if no allowance is made for transport charges and import and export duties. If, for instance, England has an all-round export tariff of 10 per cent or if France has an all-round import tariff of 10 per cent, the net external prices of English goods to Frenchmen will be increased by 10 per cent and the pound should theoretically be some 10 per cent cheaper in terms of francs than would be suggested by any index numbers which accurately measured true purchasing power parity. The theory is also defective because it ignores the effect of balance of accounts which are independent of internal purchasing powers and which, as has already been shown, materially affect the determination of the rate of exchange. Moreover, the assumption is made that no change has occurred in the various regulations influencing the flow of commodities and securities between the countries. In this age of tariffs, export subsidies, exchange quotas, embargoes etc., the descrepancy from this source would necessarily be large. Altogether, these important limitations reduce the usefulness of the formula to that of giving a rough approximation of the equilibrium exchange rate when it is known that the disturbing changes have been slight. In short, the rate of exchange determined by the purchasing power parity theory is a *normal* rate, that is, an *imaginary* rate which will *tend* to be determined in the long period if other things remain unchanged. Other things, however, do not remain unchanged. There are day-to-day changes in the balance of trade and the rate of exchange moves with them. Hence, the normal or the theoretical rate of exchange is determined by the purchasing power parity but the balance of trade theory accounts for the temporary, seasonal or occasional changes in the rate of exchange. The *permanent* par itself is movable and will move only when there are differences in the price-levels.

There is yet a *fourth* group of countries of which India is a true representative—countries between which exchange is not allowed to be determined by natural forces (*i. e.*, import or export of specie) but is *artificially regulated* by the Government. In this case the dependent country has only a token coin functioning as a standard coin and its exchange value in terms of the currency of the mother country is artificially fixed. Owing to the difficulty of sending gold to and fro, there is a danger of the exchange rising above or falling below the lower specie point and the Government has to control exchange operations by creating its own bills of exchange and by making them available to the public at fixed

prices.[1] The presence of these bills in sufficient quantities keeps the exchange "*pegged*" within narrow limits. This system would break down only if the supply of these bills is restricted or if the prices at which the Government may offer them to the public are substantially increased. In the case of India before the last War the token rupee was linked to the British sterling at Re. 1=16d. and the exchange was maintained between the specie points (1s. 4⅛d. and 1s. 3·29/32d.) through the sale of Council Bills and Reverse Council Bills. Whenever owing to a favourable balance of trade the value of the rupee threatened to rise above the upper specie point the Secretary of State offered to sell to the English public bills drawn by himself on the Governor-General-in Council at any price varying between the par (1s. 4d.) and the upper specie point (1s. 4⅛d.). The purchasers of these bills (called the Council Bills) sent them to their creditors in India who were ultimately paid by the Government of India or their bankers. It may be incidentally mentioned here that the Council Bills, apart from stabilising exchange, were regarded as a very convenient means of remitting Home Charges, *i.e.*, the amount of money which the Government of India has to send annually to defray the expenses of the Secretary of State.[2] They also tended (in theory at least) to contract currency and lower prices in England and bring about a corresponding rise of prices in India. Similarly, in the event of exchange falling below the lower specie point, the sale of Council

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1 Many other methods may be adopted in times of emergency. During the war period, for example, the Sterling-Dollar exchange rate was "pegged" at £1= \$4·76½. At that time England had heavy payments to make to the United States in respect of food, munitions and raw materials supplied to herself and to the Allies. The heavy depreciation of the pound and the absence of counter-balancing exports would have caused the dollar exchange to fall far below the normal parity (\$4·86). The British Government, however, met the situation by fixing the exchange at an arbitrary figure, namely, \$4·76½ and maintained it at first by limiting the imports of "non-essentials" into England and by raising dollar credits with private firms in New York which were sold at \$4·76½ for £1 to British armament firms and importers of raw materials to enable them to discharge their American debts. The American and Canadian bonds held by residents in England were offered as securities—the holders of those bonds being compelled first by a very heavy income tax and then by legislation to surrender these securities to the Treasury. The securities thus obtained were either sold in New York or deposited as collaterals for loans and thus formed an invisible export which paid for the import of food and ammunition by the Allies. When the supply of those securities had practically come to an end the American Government raised loans in America for the British Government and therewith paid the United States exporters for the supplies of munitions and food sent to England and her Allies.

2 In respect of:

1. Interest on the sterling debt of India.
2. Interest on the stock of the Government Railway Companies ;
3. Pensions and furloughs of English officials payable in England ;
4. Army effective and non-effective charges ;
5. Purchases of stores in England on behalf of the Government of India ; and
6. The cost of Administration in England on behalf of the Government of India.

Bills was stopped and the Governor-General-in-Council volunteered to sell Bills—called Reverse Council Bills—drawn by himself on the Secretary of State at prices varying between the par (1s. 4d.) and the lower specie point (1s. 3·29/32d.). Currency was contracted in India and by creating sufficient exchange bills (official) the exchange was prevented from deteriorating. Because the balance of trade was persistently in favour of India, the system worked satisfactorily only so long as the Government had sufficient money in the reserves in India to pay out the Council Bills and broke down during the war period when the funds ran out.

Even nowadays the rupee has been "pegged" to sterling at Re. 1=18d. but the old method of Council Bills and Reverse Council Bills has been replaced by the system of *Purchase of Sterling.* Whenever the balance of trade is favourable to India and the rupee-sterling exchange rate threatens to rise above 1s. 6¼d. (the upper specie point) the Government of India prevails upon the exchange banks to put their sterling resources in London at their disposal in exchange for money paid to them in India. This system was introduced in 1923-24 but was greatly extended in 1924-25 when the purchase of sterling was resorted to as a principal method of remittance, the weekly sales of Council Bills being started only when there was a great demand for them. The Hilton Young Commission recommended the purchase by competitive public tender and the publication of the weekly returns of remittances. Accordingly, since April 1927, the system of purchase of sterling in India by public tender has been inaugurated. Tenders are received on one day each week, usually on Wednesday, simultaneously in Calcutta, Bombay, Madras and Karachi and particulars of the amounts allotted are published on the following day in each of these places. Between the days on which the tenders are received, intermediates are on offer at the offices of the Reserve Bank of India at these places at a rate 1/32d. above the highest rate accepted on the previous day on which the tenders were received.[1]

The present system (like its predecessor) is an essential part of the complicated mechanism of foreign exchange and is also utilised for the annual remittance of Home Charges to the Secretary of State. It is preferred to the old system of Council Bills because it enables the Government to ascertain the factors much more accurately and promptly and to regulate the purchase of sterling much more satisfactorily with reference to the varying conditions of the market. It is also useful to the exchange banks which need not raise loans in England for they can always sell their sterling bills to the Government in India.

Main Influences on the Exchanges. We are now in a position to study the principal factors affecting the exchange value of

1 Also read Jather and Beri—*Indian Economics*, Vol. II., pp. 390-92 and the Reports of the Controller of Currency for 1924-27.

currencies. These factors may be summarised as :—

1. *Short-term factors*—(a) Commercial.
   (b) Financial.
2. *Long-term factors*—(a) Currency and credit conditions.
   (b) Political and industrial conditions.

Let us deal with them one by one.

SHORT-TERM FACTORS.

Commercial. We have seen that the rate of exchange depends upon the demand and supply of exchange bills which are drawn in response to trade requirements and that the exchange tends to be favourable to a country which exports more than what it imports and unfavourable to a country whose imports exceed its exports—the words 'imports' and 'exports' being used in a very wide sense so as to include both visible and invisible items.

Financial. The development of banking and the ease and rapidity with which funds can be transferred from one centre to another have rendered banking and financial operations a most powerful factor affecting exchange rates. For instance, if country A is exporting capital to country B, the supply of A's money offered against B's money will be increased and the rate of exchange will be favourable to B. Similarly, when it is feared that one currency or another will fall considerably in exchange value, quite large movements of capital may take place, not for long-term investment, but in the hope of making a gain or avoiding a loss on exchange movements. Movements of capital may also be due to Stock Exchange operations. It is a well-known fact that Governments and Municipalities often raise loans in foreign countries to meet the needs which the savings of their own people are not able to satisfy. Big industries likewise invite international subscriptions to their capital. If such capital stock and shares are subscribed for internationally it follows that they must be marketable internationally and there are now many securities which can be dealt in on all the principal stock markets of the world. The creation of these international loans, payment of interest thereon, and their repayment etc., naturally lead to changes in the rates of exchange. For instance, "when a country gives loans to another, the loans have to be transferred into the foreign currency. Its demand for foreign currency increases and the rate of exchange moves against it. Similarly, when home investors buy foreign securities or home securities are sold by foreigners the rate falls. But when the loans are being repaid, or when the foreigners buy domestic securities, the demand for home currency on their part rises and the rate of exchange rises."[1]

The Bank Rate also plays an important part in the determination of exchange rates. When it is high (in relation to other centres) foreigners send funds to that country to earn higher interest. The demand for home currency rises and the rate of exchange moves up. The opposite happens when the Bank Rate is lowered.

1 Sen and Das—*An Introduction to Economic Theory*, p. 432.

Another financial operation, the results of which affect rates of exchange, is that of "*arbitrage in exchange*." The term "*arbitrage*" is applied to the simultaneous buying and selling of the same article in two or more markets. "*Arbitrage in exchange*" is, therefore, an operation in exchange by which speculators endeavour to profit by difference in the rates of exchange for the same time. They buy up currency in a centre where it is cheap and re-sell in a centre where it is dear, the margin of difference constituting their profit.[1] The effect of such operations is to narrow down fluctuations in rates or to cause the world price of a currency to move in the same direction in all centres all at once, since a demand for any currency in a certain certre is met by transfers of supplies of that currency from centres where the demand is not so great and the price is consequently lower. Any excessive supply of a currency in one centre is similarly transferred to other centres where the supply is smaller and world supply and demand are thus set off against each other.

LONG-TERM FACTORS.

Currency and Credit Conditions. They exercise important influences on the rates of exchange. If, for example, we know that the note circulation of a country is increasing out of all proportion to its trade we may expect a fall in the purchasing power of money and a rise of prices. This must have an adverse effect upon the export trade of the country and consequently upon its exchange rate. A fall in a rate of exchange sets in motion forces which tend to bring prices down. Low exchange encourages imports and discourages exports and thus leads to the outflow of gold. To the extent gold goes out of the country there is a reduction in currency and credit and a corresponding fall in internal prices.

Political and Industrial Conditions. The national budget is a useful index to national finances. A country where expenditure is scrupulously adjusted to the income inspires universal confidence. Speculators in exchange buy up the currency of such country in anticipation of a rise in exchange due to increased prosperity. On the other hand, where it appears that a country is spending more than the state of its national prosperity justifies, fresh taxation will be inevitable. The speculators in exchange will sell the currency of such country in anticipation of a fall in its international value owing to reduction of exports (due to high prices) and to the general falling off in national prosperity.

The political outlook in a country is also a potent factor both in exchange speculation and in the international movement of capital. A stable government, the strict maintenance of law and order, the protection of private wealth and property and the relation

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1 When such dealings are confined to two countries they are called "*simple or direct*" arbitrage but when they are carried out in a third currency between two centres or in four or more currencies between three or more centres simultaneously they are known as "*compound*" or *two-point* (*three-point* etc.,) arbitrage.

between labour and capital etc., decide whether capital should flow in or go out of a country and, therefore, whether exchange should be favourable or otherwise.

EXCHANGE CONTROL.[1]

Having studied the causes of exchange fluctuations, it remains for us to examine the need and modes of exchange control which, for our purpose, will include all Governmental interference.

Objects of Exchange Control. The need of stable prices and exchange as a necessary condition for the development of trade and national prosperity has often been emphasised. The Government must control exchange especially at times when it threatens to sink to levels at which trading with other countries will be impossible. Control of exchange may also be necessary to prevent a flight of capital and to prevent the gold resources of the Central Bank from falling very low indeed, if possible, to increase them. As the strength or weakness of exchange depends upon the number of bills available for sale and purchase, the object of the exchange control is to restrict the demand for foreign exchange and simultaneously to increase its supply.

Method of Exchange Control.

1. *Regulation of Merchandise Movement—Tariffs, Quotas and Licences.* Since it is the in-and-out movement of merchandise which primarily affects any exchange rate, it is only logical that the exchange should be controlled by regulating the amount of imports and exports. This is usually accomplished by imposing restrictive or even prohibitive duties on the import of certain goods and/or by offering subsidies, bounties or "drawbacks" to exports of certain staple home products. If the country's balance of payments still remains adverse more drastic steps may be taken to control trade by means of "*quotas*" and "*licences*." Under the "*quota*" system the Government allows only a fixed quantity of certain articles to be imported in a fixed period of time. When the total has been reached no more goods of that particular kind can be imported until the beginning of the next quota period. "*Licensing*" of imports also has the same effect. By issuing licences for imports (and exports) the Government can not only regulate the amount of commodities imported (and exported) but it can also regulate the amount coming from (and going to) different countries.

2. *Rationing the Supply of Exchange.* The State may (through the Central Bank) assume the exclusive right of buying and selling

1 The term has been variously defined. Paul Einzig, for example, has included under this denomination *all* interference by monetary authorities on the exchange markets. See his *Exchange Control*, London, 1934.

Heilperin, on the other hand, believes that exchange control consists only in the centralisation of all dealings in foreign exchange in the hands of a public authority. See his *International Monetary Economics*, p. 238.

The Report on Exchange Control, submitted by a Committee composed of members of the Economic and Financial Committee of the League of Nations, Geneva, 1938, provides no explicit definition whatever.

foreign exchange at fixed rates. These may be rates corresponding to the parities which existed at the time when exchange control was introduced, but they may be other rates too. All open market dealings in bills, in this case, are done away with—the Central Bank being the only place where foreign exchange can be bought and sold and the official price being the only price at which payments can be made or received.[1]

3. *Exchange Equalization Fund.* It is created to enable the Central Bank to control exchange when the Government has decided upon it. Great Britain was the first country to set up such a fund. It began in June, 1932, with assets of about 150 million in Treasury bills, augmented in April 1933, by a further £200 million of Treasury bills, and in June 1937, with yet a further $200 million, and it is still in existence. Its main objects.........was to affect purely speculative movements in sterling exchange rates whilst allowing "real" cause to affect the long-term trend. The Fund was to smooth out temporary fluctuations."[2] The assets of the fund consist of sterling (in the form of Treasury bills) and gold. The power of the Central Bank to keep sterling down is limited by the extent of its sterling assets, and its power to keep sterling up is limited by the extent of its foreign assets.

Some other countries, notably, France and the United States, have also established similar funds.

4. *Money Rates—The Bank Rate.* We have already seen that the exchange rates are affected by the rate for money *i.e.*, the rates of interest. When interest rates at any important centre tend to rise, exchange rates on that point tend also to rise by reason of the natural desire to send money to any market where a greater return can be had for its use. Conversely, when interest rates go down, exchange rates on that point are lowered through the withdrawal of loanable capital which inevitably takes place. Hence, exchange can be effectively controlled by controlling the rate for money. Money rates can be controlled by regulating the Bank Rate *i.e.*, the rate at which bills can be rediscounted at the Central Bank, because no bank will discount a bill for a customer at a rate very much lower than the official rate which it knows it will itself have to pay at the Central Bank in case rediscounting of the bill becomes advisable or necessary.

5. *Blocked Accounts.* The Government may take steps to forbid the transfer out of the country of any sums in the home currency owned by foreigners. Such balances are then described as "frozen." The foreigners who own them are not allowed to draw upon them or are allowed to do so only to a limited extent and for a specified purpose such as to cover their personal expenditure while travelling in that country. Hence they are prevented not only from converting

1 Virtually it amounts to "exchange pegging" which has already been discussed.

2 Benham—*Economics*, p. 440.

them into a foreign currency but even from utilizing them freely for purchasing goods and paying debts within the country.

6. *Clearing Agreements.* They are insisted upon, in the interest of their nationals, by countries exporting to a country practising exchange control. The countries controlling exchange have to guarantee, before export to them is permitted, that prompt payment will be made for all articles delivered to them.

Exchange Control Between the Two World Wars. Some of these methods were successfully tried during the two world wars. During the intervening period, when the gold standard was restored in most countries, the need for exchange control seemed to disappear but it was soon discovered that the adoption of the gold standard was not a panacea for all ills. Among other defects, it brought the problem of deflation with its concomitant evils, into outstanding prominence.[1] This deflation in the gold-using countries more than doubled the wealth-value (purchasing power) of gold in the years 1930-35 and price-level of goods in terms of gold fell by more than half. One country after another, feeling the strain intolerable, abandoned the attempt to keep pace with the appreciation of gold and acquiesced in a depreciation or, in some instances, a devaluation of its money unit till in 1936 none still held out.

The chief purpose of deflation was to protect the reserve by a direct control of a country's external payments. If the external payments of a country could be limited to what its exports, visible and invisible, earned, there could be no loss of reserves and no need of deflationary pressure to maintain them. In that device Germany led the way and many countries followed. But if external payments were to be restricted, some regard had to be paid to the transactions giving rise to them. The importation of goods could be limited by a licensing system through the customs administration. But, to restrict external payments as a whole, something much more comprehensive was needed. Every transaction to be permitted would have to be justified by its purpose. Foreign exchange control therefore meant the concentration of *all* purchases or acquisitions of foreign money or assets in a single channel, a governmental agency which could give or withhold permission in every individual case. The restriction of imported goods by the customs would only apply to material products, and exchange control would extend the restriction to immaterial products, services rendered from abroad, by preventing payments unless permission were obtained. But the main purpose of

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1 A major war nearly always involves the belligerent countries in inflationary finance ; they have recourse to paper currency and their metallic currency is driven abroad. If the quantity of metallic currency thus displaced is large, there results a monetary expansion in the countries receiving it and the price-level of commodities in world markets rises. The restoration of peace reverses the process. Countries returning from paper to metal absorb supplies of the metal from abroad and inflict a monetary contraction and a fall of prices on those which have remained on a metallic standard and which find their monetary reserves reduced and even threatened with exhaustion (H. Watrey).

exchange control is to prevent *capital* transactions in foreign exchange. When a country's reserves are approaching exhaustion, there is likely to be a general fear that the foreign exchange value of its money unit will fall and people will try to escape loss on the money they hold by buying foreign exchange or investing in foreign securities or property while there is yet time. A panic flight from the currency thus inspired would sweep away the remnant of the reserve in a twinkling. Exchange control, if effectively enforced, prevents that catastrophe. It can maintain the money unit at any desired value in the foreign exchange market.

In the years following the German banking crisis of 1931 the money units of the world sorted themselves out into the strong and the weak, the weak relying on exchange control and the strong dispensing with it. The weak units were those which were overvalued.

Exchange control was imposed to protect reserves. Reserves did not necessarily mean gold ; they might be reserves of foreign exchange. But foreign exchange, to serve the purposes of a reserve, had to be freely available to discharge debit balances in any part of the world, and only strong currencies would fulfil that condition. If a weak currency is overvalued, that means that it is not easily saleable at the quoted value. Consequently, the countries practising foreign exchange control did not want to hold *one another's currencies*. Within the circle of weak currencies every country was anxious to spend as much as it received and to avoid being left with a balance. Outside that circle all were anxious to sell as much as possible and to buy as little as possible and so to acquire balances of strong currencies.

The Bilateral Agreements. The outcome was a system of bilateral clearing or barter agreements among the weak-currency countries, under which each used up whatever it received of the other's money in paying for imports from them. This was not only a solution for their foreign exchange problems but a partial remedy for the disadvantages under which over-valued money units placed their exports. The weak currencies were not over-valued in terms of one another, but only in terms of the strong currencies. The circle of weak-currency countries became through these agreements one of preference for one another and of discrimination against the strong currency countries in international trade. The discrimination aggravated the distress which the strong currency countries were suffering from the depression with the result that Great Britain in 1931 and the United States in 1933 abandoned gold parity and allowed their currencies to depreciate. The bilateral trade agreements based on exchange controls became discredited.

The exigencies of World War II, however gave the agreements a somewhat different form. Sterling was a weak currency only in the sense that the country was incurring external indebtedness recklessly to procure resources for the waging of war. The pound

sterling retained its old prestige. The countries of the Sterling Area continued to hold reserves in the form of liquid assets in London. Many other countries were willing to allow their holding of sterling to accumulate to a considerable extent. The sterling so accumulated was tied up by the British Exchange Control and except by express permission, could only be used for payments in the Sterling Area.

Under pressure of war expenditure the sterling funds held by overseas countries in London were swollen to enormous totals. If that was to mean an equivalent potential demand for British goods, it looked ominously like an adaptation of the bilateral agreements of the nineteen-thirties on an exaggerated scale.

The prospects of a permanent extension of the practice of bilateral agreements based on exchange control aroused the fear of the U.S.A. They feared that Great Britain would once again capture world markets to the detriment of other countries including the U.S.A. But as luck would have it England asked for American assistance. The help was readily given by the Lease-lend Act of 1941. After Pearl Harbour the two nations undertook to help each other and the Mutual Aid Agreement was signed on 23rd February, 1943. The Agreement specifically mentioned "the elimination of all forms of discriminatory treatment in international commerce and the reduction of tariffs and other trade barriers" as the aim of the two major powers.

The Multi-lateral Agreements. After some time Lord Keynes evolved a plan for restoring "multi-lateral" clearing of international payments, of which the essential feature was to ease the strain on monetary reserves, which had been the occasion in the first place of the exchange controls, and hence of the bilateral agreements. His plan was to reinforce the reserve of every participating country by giving it the right to borrow from an International Clearing Union up to an assigned limit. The Clearing Union would reckon its transactions in a special international money of account (*"bancor"*) which could be acquired not only by borrowing but by selling gold to the Union. The unit of bancor, however, was not to be irrevocably fixed in terms of gold; its value could be varied under suitable conditions, if the governing authorities of the Union found a change desirable.

The American Plan. The Americans came out with a counter proposal embodying a plan propounded by Dr. Harry White. Whereas Lord Keynes had proposed to supplement monetary reserves with a right to an advance in bancor from the Clearing Union, the American proposal contemplated the creation of an International Fund to which every participating country would contribute a quota of its own currency. The Fund would constitute a reserve of foreign exchange containing initially all the currencies in due proportion. Upon this reserve any participating country was to have the right to draw by buying whatever foreign exchange it might need with its own money.

The Canadian Plan. The Canadians put forward yet another plan which was, in many respects, better than the British and the American plans for no other reason than that "the Canadian experts had the advantage of seeing the American and the British Plans before formulating their plan and it is easier to suggest modifications in a prepared draft than to formulate a satisfactory plan *de novo*."[1]

After further discussion it was possible to evolve a joint plan which was formally accepted by the United Nations Monetary and Financial Conference held at Brettonwoods in July 1944.

The Brettonwoods Agreement. The decisions arrived at at Brettenwoods led to the creation of an International Monetary Fund, and an International Bank for Reconstruction and Development. Since the two institutions are very much in the picture nowadays it may be worthwhile to devote a few lines to the discussion of their objects and substance and to the examination of their achievements up-to-date.

The International Monetary Fund. The aims of the Fund are :—

(1) to promote exchange stability.

(2) to maintain orderly exchange agreements among members,

(3) to avoid competitive exchange depreciation,

(4) to assist in the establishment of a multilateral system of payments in respect of current transactions between members, and

(5) to eliminate foreign exchange restrictions which hamper the growth of world trade. By making the Fund's resources available to member countries, the Fund provides them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity and also shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The Fund is composed of quotas subscribed by the participating countries, partly in gold, partly from each country in its own currency. The gold portion is either 25 per cent quota *or 10 per cent of the country's* net official holdings of gold and U. S. dollars, whichever is less. Quotas are subject to review at five-year intervals.

The currency portion of a member's quota is the sum of its own money which it is placing at the disposal of the other members. Any member can buy the money of any other from the Fund, subject to certain conditions. Its own quota supplies a measure of the amount that may be bought ; any excess of its purchases from the Fund over the sales of its money by the Fund to other members

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1 Rao—*India and the International Currency Plans*, p. 69.

causes an increase in the Fund's holding of its currency, and that increase is not to exceed one-fourth of the quota in any period of twelve months ; nor may the increase be such as to raise the holding to more than double the quota.

Ordinarily any member can buy the money of any other from the Fund. But it may happen that a member's currency is so much in demand that the Fund's holding of it is threatened with exhaustion. The Fund can invite the member to lend a further supply of its currency, or can *require* it to sell a further supply to the Fund for gold. Thus, "if it becomes evident to the Fund that the demand for a member's currency seriously threatens the Fund's ability to supply that currency, the Fund.................shall formally declare such currency scarce, and shall thenceforth apportion its existing and accruing supply of the scarce currency with due regard to the relative needs of the members, the general international economic situation and any other pertinent considerations."

Member countries have to declare the par value of their currency in terms of gold as a common denominator or in terms of the United States dollar of the weight and fineness in effect on July 1, 1944. The pars of exchange are not absolutely fixed. If the proposed change, together with all previous changes, does not exceed 10 per cent of the initial par value, the Fund shall not object ; if the change does not exceed a further 10 per cent of the initial par value, the Fund will have to declare its attitude within seventy-two hours. Par value of the rupee in terms of U.S.A. dollar as intimated by the Government of India to the Fund is 30.25 cents.

The Fund is authorised to impose three types of fees or charges in transactions with its members. In the first place, a service charge of ·75 per cent of the parity price of a currency is assessed upon the member which buys it in exchange for its own currency. Secondly, the Fund has the authority to assess reasonable handling charges in buying and selling gold. Thirdly, the fund is required to levy a sliding scale of charges upon each member when its average daily holdings of the member's currency exceed the quota. As a rule, the three varieties of charges are payable in gold. However, the agreement permits members whose monetary reserves are relatively small to pay a portion of the charges in their own currencies. The income derived from the foregoing charges is used, as far as is necessary, to meet the operating expenses of the Fund. Whatever remains after the payment of expenses may be set aside as a reserve or may be distributed to the members as dividends in such proportion as the Board of Governors decides. Dividends are payable to each country in its own currency.

The management of the Fund is vested in a Board of Governors, Executive Directors, a Managing Director and the staff. The Board of Governors, which is the custodian of all the powers of the Fund, consists of a Governor and an alternate appointed by each member. Except in specific cases, the decisions of the Fund are made by a majority of the votes cast. The Executive Directors to whom powers

are delegated by the Board conduct the general operations of the Fund. Their minimum number is twelve of whom five are appointed by each of the five members having the largest quotas and seven are elected. The Managing Director, who cannot be either a governor or an executive director, is selected by the Executive Directors. He is the chairman of the Directors but has no right to vote except in case of an equal division. In appointing the staff, the Managing Director, consistently with the maintenance of efficiency, has to pay due regard to geographical distribution.

The Fund made a promising start. It got every possible help and co-operation from the member and non-member countries. In June, 1947 there were 44 members and two more, Australia and Finland, were waiting to be admitted. Soviet Union and some of the ex-enemy countries such as Germany and Japan are not yet on the membership list.

The quotas of members add to $7,721·5 million, the increase of quota by $324 million up to 1951-52 being due to the admission of new members as well as increase in the quota of France. Paraguay, Iran and Egypt have already requested for an increase in quota and for Paraguay it has already been raised to $3·5 million. The task of establishing initial par values of the member's currencies was completed in December 1946 and of the 34 members for whose currencies par values had been agreed, 29 had completed payment of their subscriptions, the total amount of subscriptions paid being equivalent to $6,535 million. The composition of the subscription is also interesting : $1,344 million in gold, $2,063 million in dollars, and $3,128 million in other member currencies and the exchange transactions were begun on 1st March, 1947. Up to June 30, 1947 it had sold $ 6 million in United States to France and $1·5 million in sterling and $6 million in United Funds to the Netherlands. Realising that gold transactions may lead to divergences from par of the external value of member currencies, it has taken action to fix margin at one-fourth of one per cent, above and below par. In June, 1947 the Fund requested its members to take prompt action to discourage international gold transactions at prices substantially above monetary reserve. The Fund is keeping itself in close touch with other institutions in the international field and besides considering terms of an agreement with United Nations it has taken active part in the work of the Conference for world trade and employment which has resulted in the creation of an International Trade Organisation. It has also provided a technical mission to Ecuador for consultation on exchange and monetary problems. Further, it is gathering information relating to the monetary uses of silver, functions of silver coins, etc., with a view to facilitating the discussions on silver problems in an internatiohal conference of interested members.

It will, however, be noted that the membership of the Fund is not global. Many countries are still out of it. Another criterion of the Fund's success in its objectives would be its ability to secure

the gradual removal of exchange restrictions and multiple currency practices. The Fund Agreement provides that such restrictions may continue during the transitional period and it is symptomatic of the disturbed and uncertain conditions over large areas of the world that most of the members are maintaining them. The United States, Panama, Mexico, Guatemala and El Salvador are the only member countries who have assumed the obligation to permit freely payments and transfers for current transactions. The main reason for the continuance of restrictions especially by European countries is, of course, the need of conserving foreign exchange by limiting the demand for imports which would otherwise, in the context of post-war reconstruction requirements and domestic inflation of prices and incomes, tend to be excessive. Multiple currency practices, too, seem to have been largely retained and the Fund is not inclined to take a doctrinaire attitude or to refuse to recognise significant differences in conditions in member countries. When, therefore, Ecuador wanted to adapt its multiple currency practices to impose a surcharge on non-essential imports, the Fund allowed it to do so. Similar concessions were also allowed to Poland, Greece, Italy and France. It is, of course, true that a necessary condition for the significant relaxation of restrictive exchange practices is the establishment of a better pattern of international payments. But the logic of it may be pushed too far ; for not all the prevailing restrictions are warranted by such considerations and there are quite a few which react adversely on the balance of payment of other countries. To these the Fund's attention has to be immediately directed. It was hoped, and not without justification, that the restoration of the transferability of the sterling in current transactions will lead to the re-establishment of a system of multilateral payments with the U. S. dollar and sterling rendered freely transferable, a multilateral system of payments would have been within sight. The hope, however, has not been fully realised and though after July 15, 1947 sterling has become formally transferable, in practice its convertibility has been limited and restricted partly by the difficulties facing the United Kingdom which have led to voluntary action by members of the British Commonwealth. The world is, therefore, still some way off from the ideal of multilateral system of payments.

For the purpose of promoting exchange stability the success of the Fund will depend largely on the general political and economic environments which are, at the moment, none too favourable. The productive efficiency of the war-damaged countries has not yet been restored to the point where they can achieve balance in their international payments with a level of trade conducive to their own and the general well-being. The distinction between hard and soft currencies has been intensified, the problem of finance has become more acute and the task of restoring convertibility is made more difficult.

The international political situation is equally hopeless. The future of Germany and Japan is still uncertain and large areas of

the world are still in turmoil. Substantial forces are being maintained by countries overseas and they are naturally imposing heavy strain on their economy. To expect the Fund to solve all these political and economic problems is preposterous, not only because the resources of the Fund are not intended for reconstruction but also because its success depends upon the action taken by different countries in the related fields of trade, relief, investment, reconstruction and development. Hence the maintenance of close liaison between the Fund and other organisations is of the highest importance and now that the International Trade Organisation has been set up, it may be hoped that all problems relating to balance of payments and the monetary reserves etc., will be solved to the total satisfaction of everybody.[1]

In recent months the Fund has been criticised for many other lapses. For instance, it has been pointed out that it has failed to stop fluctuations in gold prices and that it readily acquiesced to the Canadian decision to grant an extra seven dollars an ounce in respect of domestic production over and above that of the year ended 30th June, 1947. Its failure to get its views on devaluation accepted by France is another instance of its failure to command the international monetary and financial situation.[2]

The Bank for Reconstruction and Development. It was intended to be the necessary adjunct to the Monetary Fund. Its primary purpose is to assist in the reconstruction and development of member countries and to ensure a high and stable value of international investment with a view to promoting the maintenance of a high level of international trade and thus of production and employment.

The Bank is designed, in the first instance, to promote foreign investment by guaranteeing in whole or in part loans made by private investors through the usual investment channels. It is only when such guaranteed loans are, for one reason or another, not available on reasonable terms or in adequate amounts, that the Bank can be called upon to supplement private investment by making loans for productive purposes out of its own capital and reserves or out of funds raised or borrowed by it.

The Bank has an authorised capital of $10,000 million, subscribed by the member countries on a quota system closely parallel to that of the Monetary Fund. One-fifth of the capital only may be called up for direct loan operations, and of this fifth one-tenth is payable in gold or U. S. dollars and the other nine-tenth in the subscriber's own currency. The four-fifth uncalled capital is in effect an underwriting of loans guaranteed by the Bank made by it

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1 Also see the *Report of the International Monetary Fund for the year ending June 30, 1947.*

2 For a masterly study of the achievements of the I. M. F. read the chairman, Camille Gutt's article in *Commerce* dated February 4, 1950.

out of funds it has borrowed, whilst the called capital will be directly available for loans by the Bank itself.

The Bank's powers of lending are subject to the following conditions :—

(1) It is to guarantee loans by others rather than make loans itself unless the borrower is unable to find a reasonable lender elsewhere ;

(2) when a loan is given or guaranteed, the government of the member country receiving the loan must itself guarantee the loan ;

(3) the Bank's guarantee will be available only when the borrowing bank can show inability to obtain a loan without the guarantee ; and

(4) the borrower must appear after proper examination likely to be able to meet his obligations *i.e.*, the Bank's resources cannot be used for gifts publicly described as "loans".

The policies and procedures of the Bank have not been, and cannot be, static, but are constantly going through a process of development. There are only two criteria from which the Board and the management of the Bank are not prepared to depart. The two criteria are these : first, the Bank is not prepared to invest in any member State more than the Bank feels that the member State has a reasonable prospect of servicing ; secondly, the Bank is not prepared to invest in any programme or project, unless it is satisfied with the economic merits of that project. The phrase "economic merits" is, of course, used in its widest possible sense. These two criteria are qualified by the fact that the amount the Bank can lend must always depend upon the availability of loanable resources.

The interest charges on direct loans are left to the discretion of the Bank. Commission rates for guarantees are, during the Bank's first ten years, limited to a range of 1 to 1½ per cent a year. All charges are payable in the original currency of the loan or in gold. Where the Bank guarantees a loan, it must see that the lender's charges are reasonable.

To begin with, the Bank had to encounter numerous difficulties. For example, there was an unpleasant controversy as to the powers and responsibilities of its president and his relationship with the Board of Governors. There were successive changes in the chairmanship and it was some months before a stable chairman could be found. Financial circles in the U.S.A. looked upon the Bank with a certain degree of coolness and suspicion. Nevertheless, the Bank has already commenced its operations both as a lender and as a borrower. It has clarified many of its basic policies[1] and

1 The most important among these principles is the "strategic use of funds" by which the funds of the Bank are to be used as to result in the greatest possible increase in productivity in the shortest possible time. A second guiding principle is that the Bank's resources should not be used simply to relieve the borrowing country of

(*Continued on next page*)

procedures and has succeeded in inducing the American public to buy its bonds to the sum of $250 million.

The Bank's first loan of $250 million was given to the Credit National of France in May 1947 and the second one of $195 million was given to the Netherlands in August. The borrowers had applied for much more but the Bank considered it expedient to lend a part adding that the question of lending the remainder may be considered in the light of the progress made as a result of the first instalment. During the year ended June 30, 1951 the Bank sanctioned as many as twenty one loans involving an aggregate amount of no less than $297·6 million for developmental projects in eleven countries. This is the largest number of loans as well as the largest amount in value to be made by the Bank in any one fiscal year since it started lending operations. That the benefits of the Bank have accrued largely to the under-developed countries is borne out by the fact that 10 out of 11 beneficiaries belonged to this category and accounted for $197 million out of the $ 297 million lent by the Bank. Also, out of a total of $1,114 million lent so far, the share of Europe is $497 million and that of Australia $100 million. The balance of $517 million, which is equal to nearly half of the total, is made up of loans granted to less developed countries. Moreover, in addition to providing financial assistance to member countries, the Bank has been rendering signal service to its members by providing them with suitable technical assistance to assess their total economic resources and to set up priorities to be followed in their development programmes. It has been sending out specialised missions to study specific aspects of a country's development programmes and has helped the formation of study groups or seminars for the purpose of establishing intellectual contacts between the specialists of member countries. It also participated in the first of a series of institutes designed to acquaint Government officials of under-developed countries with techniques of programming and project control. Prominent among the countries that made good use of these technical facilities were Columbia, Turkey, Cuba, Guatemala, Iraq and Ceylon.

During the first year, the membership of the Bank increased from 38 to 45. On account of the new members and the increase in the capital subscription of France by $75 million the Bank's total subscribed capital has increased from $7,670 million to $8,245 million in August, 1947. In 1954, it reached $9,148·5 million.

Nevertheless, this amount is regarded disappointingly meagre in the context of the immense needs of global reconstruction. The

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tasks which that country could reasonably be expected to perform. Thirdly, the Bank seeks to limit its commitments only to the immediate future. A single loan application may relate to a reconstruction or development plan which may take several years to complete. In such a case the Bank will not grant loans for the whole period of the plan but will only lend, in the first instance, to meet the needs of a limited period, further requirements being subject to scrutiny at a later date.

blame, however, cannot be laid entirely at the door of the Bank. The problem of reconstruction is deeper and more difficult than was envisaged at Brettonwoods and the needs also are far greater. Forms of assistance such as contemplated under the Marshall Plan, which are beyond the competence and capacity of the Bank, have become necessary.

The loanable resources of the Bank are strictly limited. The capital funds of the Bank required to be paid up by the member countries amount only to 20 per cent of its subscribed capital, the remaining 80 per cent being subject to call only if needed to meet the obligations of the Bank. In August 1947, the paid-up capital amounted only to about $1,600 million, of which U.S. dollars, the only currency available for effective purchase, was only about 725 million. In recent years the Bank has endeavoured to broaden the source of supply for funds required by it. The member countries have been persuaded to increase their capital subscriptions and much progress has also been made in developing markets for the Bank's bonds in the territories of other member countries. The cumulative result of all these developments is that the aggregate amount of the Bank's direct and guaranteed indebtedness held by the non-U.S. investors exceeds the equivalent of $60 million. This is not satisfactory. The Bank has still to depend for its resources to a very great extent on the sale of its securities to the American public. The capital-hungry countries should, therefore, attempt to attract the flow of private capital and for that purpose effect necessary financial reforms, control inflation, maintain sound budgetary position and improve their productive capacity.

Exchange Control in India.

During World War I the rupee-sterling exchange fluctuated very widely and speculation in exchange was rampant years after the war had terminated. With the outbreak of World War II the Government decided to prevent the repetition of the old episode. The Reserve Bank of India was charged with the duty of controlling exchange within the sterling area and the Bank created a new department, the Exchange Control Department, for this purpose. Dealings in foreign exchange (and in gold), except with the approval of the Reserve Bank, were prohibited by the Defence of India Rules and the Bank was expected to provide reasonable exchange facilities for certain approved purposes such as for meeting reasonable business requirements in the fulfilment of war and pre-war contracts and for reasonable travelling or personal expenses. The actual task of dealing with the public was, however, entrusted to all the recognised exchange banks and those of the scheduled banks which had in the past dealt in foreign exchange subject to the control and supervision of the Reserve Bank. In order to make the control of exchange effective, dealings in bullion and securities have had to be rigorously controlled. For instance, export of gold to the United Kingdom is only permitted provided it is consigned to one of the London bullion brokers authorised by the Bank of

England to deal in bullion. Licences for shipment to the U.S.A. are only granted to authorised dealers in foreign exchange provided they undertake to surrender the dollar proceeds of the gold to the Reserve Bank of India. Imports of gold into India are also licensed and are permitted provided no expenditure of U.S. dollars or other important currency is entailed. Similarly, for some time the acquisition of securities from any person not resident in India or Burma and the export of securities without the permission of the Reserve Bank were prohibited. Holders of foreign securities were required to get licence from the Bank. These licences were, however, cancelled in 1940-41 when the Government took over all U. S. dollar balances and securities. Restrictions were also imposed on the taking of jewellery and cash out of India. In short, the Reserve Bank has done everything possible to restrict remittances to the minimum and to ensure that the foreign exchange proceeds of exports and of holdings of gold and securities of nationals are made available to the country for the purchase of essential requirements from abroad.

The policy of exchange control, as we know, has been eminently successful. But it has meant a great deal of work for the Reserve Bank of India. The Exchange Control Department of the Bank has not only had to frame rules and regulations in connection with the control of dealings in foreign exchange but it has had to check up returns from banks and remitters' statements in order to see that the regulations were being observed. It has also acted as the licencing authority for dealing in foreign securities, the export and import of gold and sovereigns and the export of money and jewels. It has also kept in touch with the Bank of England and other Empire controls.[1]

In recent years certain events have occurred which are likely to have considerable influence on the Exchange Control System. The first of these was the Anglo-American Loan Agreement signed in July, '46. In terms of the Agreement, the United Kingdom undertook to negotiate with the holders of the sterling balances for the settlement of these balances and to make currently earned sterling multilaterally convertible for current transactions within one year of the signature of the Agreement. Consequent on this obligation to negotiate settlement of the sterling balances, a delegation from the United Kingdom visited India in February 1947 for a preliminary discussion.

Another factor conditioning the background to foreign exchange relationships is the establishment of the International Monetary Fund and the International Bank for Reconstruction and Development which we have already discussed at some length. Consequent on India's membership of the Fund and the fixing of par values in accordance with the Articles of the Fund Agreement, sterling has ceased to be a sole determinant of the external value of the rupee. The convertibility of the rupee into other currencies was, therefore, provided for

1 *Functions and Working of the Reserve Bank of India*, pp. 80-88. Also see Chapter XIII.

by the enactment of the Reserve Bank of India (Second Amendment) Act, 1947 which was passed by the Central Legislature in April, 1947. The amendment repeated Sections 40 and 41 of the Reserve Bank of India Act which had obliged the Bank to buy and sell sterling without limit between certain specified rates above and below 1s. 6d. per rupee and replaced them by a Section which requires the Reserve Bank to buy and sell foreign exchange at such rates and on such terms and conditions as the Central Government may determine from time to time in conformity with their obligations as a member of the Fund.

Foreign Exchange Regulation Act, 1947. Another important event concerning Exchange Control was the coming into force on 25th March, 1947 of the Foreign Exchange Regulation Act, 1947 superseding the Financial Provisions of the Defence of India Rules under which authority for controlling foreign exchange had been derived, as the extension by the Emergency Provisions (Continuance) Ordinance, 1946 of the operations of these rules by six months finally expired on 31st March, 1947.

The Act retains the powers granted under the Financial Provisions of the Defence of India Rules with certain modifications and closely follows the Exchange Control Bill in the United Kingdom. The effect of the new measure is to continue the existing system of Exchange Control under which transactions in foreign exchange are confined to banks authorised to deal in foreign currencies by the Reserve Bank of India which acts as the exchange control authority in its capacity as agents of the Government of India. One important change in the wording of the new Act from the Defence of India Rules which it supersedes is in Section 5 restricting certain payments. This section is similar to the previous Defence of India Rule 92-A except that it prohibits transactions with any person resident outside India, while the Defence of India Rule only prohibited transactions with persons resident outside the sterling area. In the absence, therefore, of a general permission from the Reserve Bank, the effect of this Section is to bring to an end the freedom of transfer between India and other countries in the sterling area. The Reserve Bank of India issued notifications the day the Act came into operation giving general permission for payments to or for the credit of or on behalf of persons resident in countries comprising the existing sterling area so that the coming into force of the Act did not result in any change in the existing Exchange Control System.

The Act is an enabling measure giving wide powers to the Central Government and the Reserve Bank to control transactions in foreign exchange securities and the import and export of bullion and currency notes. The manner and degree of control will be determined by the policy of the Government, which will be influenced by the balance of payments position of the country and Government's obligations to the I.M.F.[1]

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1 *Report on Currency and Finance for the year 1946-7 (Reserve Bank).*

The Act (Foreign Exchange Regulation, 1947) was further amended on 20th November, 1947 to provide for complications arising out of the division of the country. It was found, for instance, that the ban on gold imports did not work because large quantities of gold were first imported into Pakistan and later smuggled into India. The amendment extended the application of the Act to include bullion brought to India in any ship or conveyance intended for an adjoining territory (*i.e.*, Pakistan).

During 1949 a few minor changes took place. For instance, following the termination of the Customs Union with French India in March 1949, the French possessions in India (with the exception of Chandernagore) came to be treated as a foreign territory and the issue of licences for the imports into these areas was stopped. Restrictions were also placed on the import of currency notes from Burma. Authorised dealers were directed to limit their purchases of Burma currency to Rs. 100 per traveller except in the case of persons travelling by the Lido route in which case the higher limit was to be Rs. 200 per person. Lastly, the Indian nationals resident in India were permitted to deal in the shares of sterling companies operating in India with two registers—one in London and the other in India—provided payments were made in rupees and the shares were on the Indian register. Nationals of India were also permitted to acquire sterling shares of such companies in the London market subject to the condition that the shares had been transferred to the Indian register before they were sent out to India. Minor changes are being made from year to year in conformity with the economic policy of the country.

SUMMARY

Definition of the Rate of Exchange. *It may be defined as the price of one unit of the currency of one country expressed in the money of the other.*

Methods of Determining Rates of Exchange. Since different countries of the world have different monetary standards the rates of exchange between them are determined by different methods. In the case of countries on the gold standard the rate of exchange is determined by the Mint Par Theory, that is, by equating the metallic contents of their respective standard coins. The rate of exchange between England on one side and the U.S.A., France and Germany, etc., on the other, before the last War, was determined by this method. Notwithstanding full freedom to send gold to and fro daily transactions between such countries are normally conducted through bills of exchange. The price of these bills is determined by their demand and supply but cannot rise above or fall below the par by more than the cost of remitting an equivalent amount of bullion from one country to the other. There are two points, therefore, within which the prices of exchange bills fluctuate—the Upper Specie Point which is calculated by adding the cost of shipment and insurance to the mint par and the Lower Specie Point which is obtained by subtracting the cost of freight and insurance from the par.

The rate of exchange between one country on the gold standard and the other on an inconvertible paper currency standard depends *entirely* on the supply and demand of bills of exchange because in the absence of the facility of importing and exporting gold, there is no help for the debtors but to discharge their obligations through exchange bills even though they may have to pay more for them. The same rule applies to all countries on an inconvertible paper currency standard. Hence, it is obvious that if the freedom to import and export gold freely does not exist, the rate of exchange is determined by the supply and demand of the bills of

exchange and because these bills are drawn in response to trade requirements, the rate of exchange may be said to be determined by the balance of trade. This is the so-called Balance of Trade Theory which states that the exchange will be favourable to a country which exports more than what it imports and against a country whose imports exceed its exports. The words "exports" and "imports" are used in the widest sense to embrace all visible as well as invisible items and include, among recorded items, all those goods and services which are not recorded but which establish the claim of one country over the currency of the other *viz.*, earnings of the nationals of one country serving abroad in so far as they are remitted to the mother country, subscriptions for charitable purposes, expenditure of a nation's Government abroad, tributes and indemnities and the expenses of students and tourists residing or travelling abroad. A specimen of the Balance of Trade of India including visible items only is given and a table from a League of Nations' publication is reproduced to give an idea of the relative importance of some of the unrecorded items during the five years before World War I. To bring figures up-to-date, two tables showing the balance of payments position of India in 1949 have been added.

Exports Pay for Imports. This is an important theory of international trade. It means that all the exports of a country (including invisible items) going to all the countries of the world tend, in the long run, to be equal to its aggregate imports (including invisible imports) coming from all the countries with whom it deals. Normally, exchange of goods for goods and services takes place and the balance is adjusted through the remittance of specie which also influences the price-levels and leads to the equation of imports and exports. It should, however, be remembered that the balance of trade is never settled within any period of twelve months like that of the official year but, if longer periods are taken, the adjustment will be seen to have taken place.

The Purchasing Power Parity Theory. It has been noticed that the rate of exchange between two countries on inconvertible paper currency standard is determined by the balance of trade. There is an alternative explanation which was offered by Gustav Cassel during the last War. According to it the rate of exchange between two countries is determined by comparing their purchasing power measured in terms of prices. If the prices of a country are higher than those of the other the currency of the former will command more goods and services than the latter and the people of that country will demand more units of the other country's currency in exchange for their own. The exchange will, therefore, be favourable to the first country and unfavourable to the other. Hence, if fluctuations in prices have taken place the new rate of exchange may be found out by multiplying the old rate by the quotient of the degree of inflation of the two currencies. This explanation is very convincing but in actual practice the rate of exchange calculated by means of the purchasing power parity theory frequently deviates from the existing rate of exchange. This is accounted for by the fact that index numbers are merely averages and that the selection of a wrong basic year or inclusion of wrong articles may give a different picture of the purchasing power of a currency altogether. Moreover violent movements of exchange rates may prevent goods from finding their true level of prices or the speculators in exchange may exert their influence in fixing a rate different from the one calculated on the basis of index numbers of prices. The theory also ignores the effect of changes in the balance of trade which as we have seen, are very important in determining the course of exchange from time to time as well as the numerous regulations influencing the flow of commodities and securities existing today.

For the purpose of fixing the rate of exchange, India falls in a different category altogether. It has got a token coin as standard coin whose value in terms of sterling was arbitrarily fixed at Re. 1 = 16d. before the last War and Re. 1 = 18d. since 1926-27. With the object of regulating exchange within the specie points the Government used to sell its own bills—called the Council and Reserve Council Bills —at approximately fixed prices. These bills also constituted an important means of remitting Home Charges, that is, the expenses of the Secretary of State incurred on behalf of the Government of India in England. The system of Council Bills has now been replaced by the system of purchase of sterling. Whenever the balance of trade is favourable to India and the rupee-sterling exchange threatens to rise above the

upper specie point the Government of India prevails upon the Exchange Banks to put their sterling resources in London at its disposal in exchange for money paid to them in India. The new system permits the Government to stabilize exchange more effectively than before. It helps the Government of India to remit money to the Secretary of State and also the Foreign Exchange Banks to draw money from England whenever their funds in India run short.

Main Factors Affecting Exchange. In a short period the rate of exchange is influenced by commercial factors *i.e.*, by the balance of trade, the rates of interest (including the Bank Rate) prevailing in different centres and arbitrage dealings. In the long period the state of currency and credit as well as the political and industrial condition of the countr y play an important part in the determination of exchange.

Exchange Control. As the stability of exchange is necessary for the trade and industries of the country as well as for the purpose of preserving the integrity of gold reserves, it is often desirable to prevent undue fluctuations of exchange by artificial means. Exchange is controlled partly by limiting imports (through quotas and licences) and stimulating exports (through bounties and subsidies) and partly by centralising all exchange dealings in the hands of the Central Bank. The Central Bank usually relies on its Bank Rate but the effectiveness of its operations depends upon the adequacy of the exchange Equalisation Fund which is often instituted to correct temporary fluctuations of Exchange. Exchange may also be controlled by "freezing" the accounts of the foreigners and by entering into Clearing Agreements.

These methods were successfully tried during the two world wars. In the inter-war period gold standard was introduced yet, the need for control did not diminish as gold was greatly appreciated and currencies were, therefore, greatly overvalued. The weak countries *i. e.*, those whose currencies were unreasonably overvalued, entered into bilateral agreements amongst themselves which had adverse effects on their trade with the stronger countries with the result that after the depression gold parity was completely given up and currency was allowed to depreciate.

World War II altered the situation a little. From the manner in which exchange was controlled in England it appeared as though the old bilateralism had been revived, this time to the advantage of Great Britain. America would not allow this to happen and made England to agree to the proposition that no determination of any kind would be permitted. Subsequently, a plan based on multilateral agreements was accepted at Brettonwoods. The plan gave birth to the I.M.F. and the Bank of Reconstruction and Development. The purpose of the Fund is to provide an international monetary mechanism,' free from the weakness of the gold standard, yet providing a high degree of exchange stability. The Fund consists of gold and currencies of member countries contributed on the basis of agreed quotas. The amount of the Fund, was, to start with, £2,220 million. A board on which all member countries are represented, manages the Fund. The voting power of each country depends upon its quotas. Members are allowed to apply to the Fund only when they cannot exchange their own currency for the currency of another country at the agreed par rate in their day-to-day exchange operations on current account. The Fund has proved quite useful so far. Nevertheless, it has often hoodwinked at practices which cut at its own roots *e. g.*, exchange restriction and multiple currency management. Perhaps the international situation is still too tense, politically and economically, to allow the Fund to function properly.

The object of the Bank, as the name suggests, is to help the member countries to launch upon schemes of reconstruction and rehabilitation with capital guaranteed or lent by the Bank. It has also done much good work because, apart from providing financial assistance to member countries, it has also placed at their disposal the services of technical experts and specialised missions for the purpose of planning and execution of their development schemes. The advantages appear to be all the greater because they have accrued largely to the under-developed countries.

Exchange Control in India.

The exchange of India has been rigorously controlled during World War II. This control has been exercised through the Reserve Bank of India which has been vested with enormous rights and duties under the Defence of India Rules. The actual task of dealing with the public has been entrusted to private banks who are

expected to provide reasonable exchange facilities subject to the control and supervision of the Reserve Bank. Dealings in bullion and securities are restricted so as to restrict the amount of remittance and to ensure that money realised from export of goods, bullion and securities is utilised for the purchase of essential articles only. The policy has been completely successful. The Anglo-American Loan Agreement, the membership of the I. M. F. and the Foreign Exchange Regulation Act, 1947, have substantially altered the working of Exchange control in India in recent years.

QUESTIONS

1. What is the rate of exchange ? Indicate the causes of fluctuation in the rate of exchange. Is there any limit to these fluctuations? If so, are they rigidly fixed ? [Delhi Inter. 1928]

2. How is the Mint Par determined between England and U.S.A. ? Show how the rate of exchange would be affected by (*a*) a loan contracted by England in U.S.A., (*b*) a relative rise in the rate of interest in London, (*c*) the outbreak of commercial crisis in New York. [Punjab B. A. 1923]

3. How is the "bullion" or "melting" point determined in the case of the rupee ? [Delhi Inter. 1932]

4. On what do the gold points depend ? Can exchange go beyond the gold points ? If so, when and how ? [Punjab B. A. 1932]

5. Explain clearly what is meant by invisible exports and imports. Why is it not easy to gauge a right amount and value of these invisible exports and imports at any particular moment ? [Delhi B. A. 1931 and 1933]

6. What do you understand by the term 'balance of trade' ? Explain the factors which bring about the equation of indebtedness between India and other foreign countries of the world. [Agra B. A. 1933]

7. In what sense it is true that imports must in the long run pay for exports ? [Calcutta B.A. 1931 and Delhi Inter. 1930]

8. What do you understand by purchasing power parity ? Examine the usefulness of this conception. [Delhi Inter. 1933 and Delhi B.A. 1934]

9. How far has Cassel's theory of foreign exchanges been seriously challenged ? How would you account for the deviation of the exchanges from the par ? [Delhi B. A. (Hons.) 1932]

10. Explain how exchange between two nations is normally maintained ? Use the Indian monetary system as your chief illustration. [Delhi Inter. 1932]

11. Describe and explain the ways which the Government of India follows for the purpose of making remittances to the London Treasury. [Delhi Inter. 1931 and Delhi B. A. (Hons.) 1931]

12. Write brief explanatory notes on :

(i) Home Charges.
(ii) Specie Points.
(iii) Council Bills.
(iv) Unfavourable Balance of Trade.
(v) Invisible Exports.
(vi) Mint Par of Exchange.
(vii) Purchase of Sterling.

13. Discuss the objects and methods of exchange control with special reference to the methods employed in India during World War II.

14. Write a brief note on the Foreign Exchange Regulation Act, 1947, passed by the Indian Legislature. [Agra M. Com. 1948]

15. Explain the functions and working of the International Monetary Fund and point out its limitations.

16. Write an intelligent note on the International Bank for Reconstruction and Development. Do you agree with the view that "the Bank's international standing has recently suffered so much that many have written it off as a disappointment" ? (*Eastern Economist,* Feb. 6, 1948, p. 300).

CHAPTER IX

MONETARY STANDARDS

From what has been said against the dangers of inflation it should be quite clear that in the interest of social justice and harmony the value of money measured in terms of commodities should be kept stable. The prices are kept stationary by adopting a suitable coin or combination of coins as standard of value in such a way as to keep the supply of currency properly adjusted to its demand, although it cannot be denied that an ideal standard which will not inflict any injury on any individual is unattainable in practice.

Bi-metallism and Mono-metallism Defined. A monetary system in which the principal or standard money is composed of coins of two different metals (say, gold *and* silver) is called Bi-metallism or Double Standard. A system in which the standard or principal coin is made of one metal (gold *or* silver) is called Mono-metallism.

Bi-metallism or Double Standard. In a true bi-metallic standard both the standard coins are freely minted, are unlimited legal tender and there is a fixed ratio of exchange between them. For instance, if in U.S.A. a silver dollar contains 16 grains of silver for every grain of gold in a gold dollar, the ratio of conversion between the two standard coins would be 16 to 1. A debtor would have the option, unless otherwise bound by his contract, of making payment either in gold or in silver money. This system has been advocated on the ground that two moneys in circulation provide a sort of *compensatory*[1] influence over each other which is very favourable for the maintenance of steady prices. For example, an increase

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1 Jevons calls it "equilibratory action" which he explains as follows :—

"If silver becomes more valuable......compared with gold, there arises at once a tendency to import gold into any country possessing the double standard so that it may be coined there and exchanged for a legally equivalent weight of silver coin to be exported again......If gold rose in value compared with silver the action would be reversed, gold would be absorbed and silver liberated. At any moment the standard of value is doubtless one metal or the other, and not both ; yet the fact that there is an alternation tends to make each vary much less than it would otherwise do. It cannot prevent both metals from falling or raising in value compared with other commodities, but it can throw variations of supply and demand over a larger area instead of having each metal to be affected merely by its own accidents."

"Imagine two reservoirs of water each subject to independent variations of supply and demand. In the absence of any connecting pipe, the level of water in each will be subject to its own fluctuations only. But if we open a connec ion, the water in both will assume a certain mean level and the effects of any excessive supply or demand will be distributed over the whole area of both reservoirs.'—*Money and the Mechanism of Exchange*, pp. 130-40.

or decrease in the production of one metal will often be counteracted by a probable decrease or increase in the production of another metal with the result that the value of money, on the whole, would be steadier under bi-metallism than under mono-metallism. Similarly, the over-valued metal will tend to drive the under-valued metal out of circulation. It alone will be presented at the mint for coinage. Its withdrawal from the bullion market will tend to raise its value there. On the other hand, the under-valued metal not being presented at the mint for coinage, will increase in supply in the market and this will tend to reduce its value. In this way the market ratio will always revert to the legal ratio whenever any divergence between the two takes place. It has also been suggested that owing to the circulation of two standard coins, the total money stock is greater and the resulting high prices more favourable for the stimulation of trade and industry. Higher prices are also supposed to be beneficial to the poor debtors of a country who, according to some, deserve greater consideration than the creditors. But by far the most important advantage urged in favour of bi-metallism is that it helps the trade of a country both with gold and silver-using countries.

Bi-metallism was adopted by Europe and America in the eighteenth centuary but it was subsequently given up owing to the wastage of precious metals and owing to the fact that the depreciated coin often manages to drive the dearer one out of circulation. This tendency of the cheaper money to drive the dearer one out of circulation (which is now called Gresham's Law) seems to have been recognised even among the ancient Greeks and needs to be studied carefully.

Gresham's Law. When different coins are in circulation all of them are not alike. Some are made of silver, others are made of gold. Some are fresh from the mint, others contain more metal than those which have been worn out by constant use. The good coins are apparently more valuable for making payments abroad and for industrial purposes and therefore the people, *so far as they can help it*, keep them in the secure corners of their pockets and transact normal business with the help of comparatively worse coins. "The reason why the cheaper of two moneys always prevails is that the choice of the use of money rests chiefly with the man who gives it in exchange, not with the man who receives it. When any one has the choice of paying his debts in either of two moneys, motives of economy will prompt him to use cheaper."[1] The same thing happens when metallic and paper currencies are in circulation side by side. The paper note, being the worse of the two, remains in active circulation while the metallic coins remain concealed until they are taken out of the hoards for emergent purposes. This tendency of bad money of driving good money out of circulation is called Gresham's Law—after Sir Thomas Gresham who called attention to this phenomenon more sharply than anybody till his time had done. The phrase "so far as they can help it"

1 Fisher—*The Purchasing Power of Money*, p. 113.

is particularly significant, for good and bad money will *both* remain in circulation so long as the good and the bad money taken together are not in excess of the monetary needs of the community. Again, an inferior money will not circulate in opposition to custom or public opinion. An inconvertible note, for example, or an old coin, will *itself be driven* out of circulation if the public refuses to accept it in preference to some better form of currency. "We have a striking illustration of the influence of custom in the history of California during the Civil War. The people of California would not use the greenbacks issued by the Government and continued to use gold whilst the rest of the United States was using paper money."[1] The law, thus, is a mere statement of a tendency and must be stated hypothetically. Kinley has put it thus: "If more than one form of currency is legally usuable in a country, and one of these is more valuable for some other use than it is for making exchanges then the inferior portion of the currency will supplant the superior to the extent that the two portions together exceed the need for currency in the country, provided that public opinion or any other economic force does not interfer ewith the operation of the self-interest of dealers in money."[2]

Now, since gold and silver are subject to different conditions, it is difficult to maintain a fixed ratio between them. If there are permanent forces causing permanent differences in the prices of gold and silver the old ratio will not be restored. The under-valued metal will gradually go out of circulation and the metallic money will consist of the over-valued money only. Consequently all bi-metallic countries are really left with *one* kind of money, that too a bad one. The compensatory action of the double standard presupposes an international agreement for the adoption of bi-metallism. There may be forces at work which, instead of correcting the discrepancies between the market and legal ratios, may accentuate the discrepancies.

International Bi-metallism. In order to guard against the operation of Gresham's Law and to maintain a fixed ratio between gold and silver coins, bi-metallism on an international basis has been suggested. The scheme would certainly be more effective but there seems to be no prospect of such an international agreement for a very long time to come.

Limping Bi-metallism. It is an imperfect form of bi-metallism. Under a "Limping" standard, two metals are unlimited legal tender but only *one* has got free coinage. Such a system comes about when, in a system of bi-metallism, before either metal can wholly expel the other, the mint is closed to the cheaper of them. It existed in France and U.S.A. before the last war when gold and silver coins were both unlimited legal tender but only gold coins had free coinage.

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1 *Wadia and Joshi, op. cit.* pp. 115-16.

2 *Money,* pp. 57-58.

Parallel Standard. Whenever it is thought desirable to keep gold and silver coins permanently in circulation side by side, the fixing of the value of one coin in terms of the other is left to the open market and the Treasury is allowed to accept them at the rate of exchange of the day. This system which was introduced in England in 1663 is called the "parallel standard" or "alternative standard." It was found unsatisfactory because traders found it very inconvenient to have to calculate continually in different coins of money which stood to each other in a fluctuating ratio.

Mono-metallism. It may exist either as gold standard or as silver standard. Silver being a cheap metal and more open to change in price is only adopted by comparatively poor and uncivilised countries like China. The more progressive countries, with larger scales of incomes and transactions, use gold as the principal medium of exchange. The price of the yellow metal generally remains very steady and the countries adopting it enjoy greater stability of purchasing power than countries on the silver standard.[1]

The Gold Standard. In modern times, the monetary standard upon which the leading nations of the world have pinned their faith is that of gold. For centuries gold has stood, rightly or wrongly as a symbol of solid, substantial wealth and has been a serviceable standard of value. At all times, and amongst people at every stage of economic development gold has been held in high esteem, partly on account of its scarcity and partly on account of its attractive appearance and utility. The technical requisites of a gold standard are :—(1) *A legislative enactmen defining the standard money unit as a definite weight of gold of a specified fineness.* For example, Act No. IV of 1927 fixed the gold value of the rupee and notes at 8,47512 grains for one rupee. (2) *The law must endow the gold unit with privileges of full legal tender.* This is usually a matter of form since gold has wide acceptance under most conditions. The procedure is, however, necessary in order to fix the legality of an offer in the settlement of dispute over debts. In India, the Act of 1927 imposed a legal obligation on the Government to buy gold at a price of Rs. 21-3-4 per tola of fine gold in the form of bars containing not less than 40 tolas. (3) *Free or unlimited coinage must be maintained.* The Government must stand ready to accept gold at its mints in unlimited quantities in exchange for which gold coin or other forms of money are given. The obligation to convert bullion into coin is modified in the case of the gold bullion standard in which case the law binds the Government to give gold in the form of bars and not coins. We will revert to this point later. (4) *Restrictions must not be placed on the free movement of gold* from the arts and industry into money and from money into the arts and industry. Nor must there be any interference whatsoever in the export and import of gold from foreign countries. (5) *All types of money must be convertible into gold* and gold reserves must be maintained

1 Also read Hawtrey—*Monetary Reconstruction,* p. 50.

to effect this conversion. The gold standard was originally adopted by a few important countries but was soon followed by the rest for the simple reason that the adoption of the gold standard brought the nation adopting it into relations of stable exchange with the richer nations and pre-eminently with England. Every addition to the list of gold standard countries increased the stability of gold by spreading over a wider field possible fluctuations in its exchange value arising from changes in the total supply or in the demand in any one country.[1] Hence, it greatly facilitates international division of labour and international investment. Mr. Keynes, the eminent economist was so enthusiastic about the efficacy of the gold standard that in the Reconstruction Number of the *Manchester Guardian* just after the First World War he wrote : "If gold standard could be reintroduced throughout Europe, we all agree that this would promote, as nothing else can, the revival not only of trade and of production but of international credit and the movement of capital to where it is needed most."[2] The recent abnormal rise of prices has led some people to suggest that gold standard has no special advantages and that the same results may be obtained by a silver standard or a well-regulated paper standard. In fact they say that the gold standard was invented by great financiers in order to enrich themselves and to get the world in their power. They invented the gold standard in order to obtain the position to manipulate slumps and booms and should be opposed by the masses who stand to lose by instability of prices and exchange.[3] But the preference for gold as the one commodity that can adequately fulfil the requirements of money cannot be dismissed as merely sentimental. It is based upon an instinctive appreciation of its economic potentialities and on an adequate analysis of its economic virtues by the civilised and thinking sections of the humanity. It provides for automatic expansion and contraction of currency with the result that commodity price levels in all gold standard countries tend to rise and fall together. More coins can be created at will and if there is a superfluity of coins, it can be removed by melting them down. It also acts as an effective check on any attempt on the part of Government to manufacture currency.

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1 See Conant—*Principles of Money and Banking*, Vol. I, p. 319.

2 Section I, pp. 3-4.

3 "When prices of ordinary commodities rise to their heights which causes the value of gold to depreciate in terms of commodities these financiers sell property and commodities heavily in order to restore the value of their gold and invest the proceeds from their sales of commodities and property in further purchases of gold, because they know that the price in general will fall further owing to the impetus. Their sale of commodities and property encourages or compels every one else to sell and this intensifies the slumps. When prices in general have fallen to the lowest limit possible and the value of gold in terms of commodities has reached its maximum, they sell much of their gold and begin buying property and commodities, and this causes every one with any money or credit left after the slump, to follow suit. This is the cause of the booms." Major Venrenen, a big Zamindar of the Punjab, at a meeting held under the auspices of the Punjab Branch of the Currency League of India on 3rd November, 1933.

Owing to the fact that there is a free and open market for gold its outward and inward flow is checked. Fluctuations in the rates of exchange are confined to specie points and loss to trade on account of instability of exchange is greatly minimised. Lastly, the greatest merit of the gold standard lies in its encouragement to international economic co-operation. It is highly important that the world should be on a common monetary basis with stable foreign exchanges. Otherwise, foreign trade and investments are seriously hindered and there is always present a threat of one nation attempting to gain selfish trade advantage over the others through the depreciation of its currency. This in turn necessarily leads to retaliatory steps by the other countries—competitive monetary depreciation, tariffs, quotas, exchange controls, and embargoes. Accentuated nationalism, intensified world poverty, and threats to peace are the inevitable consequences. The gold standard unquestionably represents the simplest and the most workable common monetary basis.

In short, the working of the gold standard may be compared to a game. So long as the rules of the game are observed fair play for all concerned is assured. We can best explain these rules, in general terms, by considering what would happen if all the gold, say, in Great Britain, consisted of gold coins in circulation. Gold coins would be exported and the quantity of money would be thereby reduced. The prices of internationally traded goods could not fall relatively to their prices elsewhere. But money incomes would fall and this would reduce the prices of "domestic" goods and services such as houses and railway rates and labour services. The fall in money incomes would reduce total money expenditure, including expenditure on imports. The fall in money costs would stimulate exports. In so far as they were not fixed by contract like external interest payments, other debit items would tend to diminish and other credit items to increase. For example, British tourist expenditure abroad would fall relatively to investment at home. In this way equilibrium would be restored in the balance of payments. The working of the gold standard would thus be automatic, requiring no intervention by the monetary authorities.

Disadvantage of the Gold Standard. It, however, does not mean that a gold standard is free from defects. It has its own limitations which make it sometimes unacceptable. The defects usually ascribed to this standard are as follows :—

1. It imposes strict limits upon the latitude of each country of independent domestic action to correct economic maladjustments. This fact applies to monetary management as well as to general economic policy and represents a sacrifice of other objectives in the interest of stable exchange rates.

2. The cost-price structures of modern economics are not flexible enough to permit downward adjustment in the

face of a loss of gold without leading to under-employment and depression.

3. Under certain conditions, it fails to provide automatic checks upon the movement of gold from one country to another.
4. In advanced countries the bulk of money supply consists of bank deposits or bank credits. In such countries the presence of gold can only have a very superficial control over the supply of money.
5. It requires a high degree of international stability for its successful operation.
6. Lastly it must be emphasised that, like most other systems, even gold standard is a fair-weather arrangement. It would last so long as conditions are normal but in times of political and economic upheavals it will be just as difficult to maintain as any other system. For instance, in times of war or when each country insists on promoting its own welfare at the cost of others, the working of the system may be greatly hampered. Similarly, it may impose an unbearable strain on a country which is passing through a process of automatic correction of unfavourable balance of payments. Unfavourable balance, persisting year after year, will cause considerable outflow of gold and if the country follows the Rule it will have to contract credit, allowing gold exports to exercise full effect on the volume of media of exchange. Reduction in the quantity of money will cause fall in incomes and price level but it is not necessary that there may be a simultaneous fall in the costs. Labourers may successfully resist the attempt of the employers to reduce wages. Fall in prices unaccompanied by corresponding fall in costs will obviously be followed by shrinkage in production and widespread unemployment thus creating a situation fraught with the gravest consequences and involving considerable strain on the national economy of the country. Besides, the price of gold itself has been very unsteady in recent years. New discoveries and improved methods of mining on one side and the chronic scarcity on the other have often caused material changes in the price.

This all suggests that the permanency of the gold-standard area, in order to minimise variations of the monetary demand for gold, is the first condition to the stability of value. Such permanency, moreover, should be realised in greater degree if all nations enter into the arrangement. It also suggests that extreme fluctuations in gold value are more likely to occur if only one or a few nations comprise the gold area.

Kinds of Gold Standard. A gold standard (or as a matter

of that, a silver standard) is generally of two types,[1] *viz* :—

1. Gold Currency Standard, and
2. Gold Bullion Standard.

Gold Currency Standard. Before 1914 the practice of coining gold was universal in gold standard countries. Free and usually gratuitous coinage at a definite mint price was one of a set of fairly definite rules recognised throughout the gold area. A second rule was to permit the free melting of coins *i.e.*, the ready conversion of gold from monetary to industrial uses. The first rule prevented the value of coined money from rising above that of an equivalent amount of the bullion ; while the second one prevented the value of the coins from falling below that of an equivalent amount of bullion. A third rule insisted upon the necessity of unrestricted movements of gold among countries as a means of balancing international payments. This linked each monetary system to the world value of gold. A fourth rule ordinarily observed was the recognition of coined gold as standard money, the highest form of circulating money. It was made a full legal tender while other forms of money were either not legal tender at all or were granted only partial legal tender power. Another one called for inter-convertibility of all forms of domestic currency and gold, so that all units of money would have the same purchasing power. Still another one recognised the need for a minimum of government interference with international trade and capital movements in order that an economic distribution of the world's gold stock might be realised. And a final rule called for no more than temporary interference by a country with the effect of inflowing or outflowing gold upon the price system. Thus the system prevailing before World War I was a more or less automatic device tending to produce a closely integrated world system of prices, stable foreign exchange rates, and a high degree of economic internationalism. But, after the war, the heritage of economic maladjustments, the rise of nationalism with an accompanying increase of government regulation of business, trade, and investment, and the more active role of central banks, all combined to make the traditional gold standard unworkable. The automatic corrective forces were no longer free to work towards an international economic equilibrium. Moreover, the people felt the necessity of economising the use of precious metals. People realised that gold was, after all, not an end in itself but a mere means to an end. It was wanted in circulation not for its own sake but because its presence inspired full public confidence in currency policy of the Govern-

1 Some writers have referred to all monetary standards having the remotest relation to gold as gold standard even though some of them lack the essential requisites of a true gold standard. L.L.B. Angas, for example, in *The Problems of the Foreign Exchanges* has, in addition to the two forms of gold standard described in this section, pointed out five more types *viz.*, Gold Exchange Standard, Variable Gold Standard, Rationed Gold Standard, "Controlled Sterling Loan" type of Gold Standard and the Authentic Gold Standard.

ment and because people in foreign countries did not hesitate to accept it in payment of dues owing to them.[1] So they said that a gold standard need not be regarded as absolutely identical with gold currency. Even Mr. Keynes, who was such a staunch advocate of gold standard stated : "I reject the policy of restoring the gold standard on *pre-war lines*......I regard the stability of prices, credit and employment as of paramount importance and feel no confidence that an old-fashioned gold standard will ever give us the modicum of stability that it used to give."[2] According to him (and other eminent economists) any system which secures *full and free convertibility of note-issue into gold in any form or shape, at all times and for all purposes*, can be called a gold standard.[3] Such a scheme would work only if there is a free gold market effectively controlled by a proper banking system.

The Gold Bullion Standard. An experiment was tried on these lines for the first time in England in 1925 when the note-issue, instead of being convertible into sovereigns and half sovereigns, was made convertible into gold *bars* containing 400 ounces of fine gold at the rate of £3 17s. 10½d. per standard ounce. The system was called the Gold Bullion Standard. In 1928, the French introduced a variation of this new system when the Bank of France was given the option of redeeming notes either in gold bars or in gold coins. As we shall see presently, a system similar to this was also recommended by the Hilton Young Commission for India in 1926.

In this type of gold standard, although gold is *theoretically* the standard of value there is little or no gold in circulation. The normal monetary circulation consists largely of token money (paper and silver) which is legally convertible into gold bars or bullion whether the gold is required for internal purposes or for export. Such a system is certainly much more *scientific* but one cannot be too sure of its successful working in practice.[4]

Difficulties of working the Gold Standard after World War I. The gold standard introduced after World War I was de-

1 See Gregory's article in *Economica*, June 1934, p. 170.

2 *A Tract on Monetary Reforms*, pp. 163-176.

3 Keynes has defined a gold standard as "in its essence an abstract standard where the price of gold has been fixed not absolutely but so far that variations of the prices are restricted within very narrow limits or what amounts to the same thing, 'where the unit of currency has an approximately fixed gold value.' "

Heilperin likewise maintains that gold-standard currency is *not* gold currency but paper money administered in such a way as to keep the price of gold stable.

In his *International Monetary Economics* published in 1939 he has drawn a distinction between a country being on the gold standard and its having a monetary system linked to gold. The former term is used to designate the traditional notion of the gold standard as a system under which the price of gold is fixed by the monetary laws of the country while the latter is used to describe a situation where currency is linked to gold in a less determined way. See pages 135-36.

4 Also see Chapter XII.

signed to economise the use of precious metals but a number of other changes that took place in monetary laws and banking practices prevented such economies from being realised. The banks, for instance, were required to keep reserves not only against notes but also against demand deposits and the fact that the central banks were expected to keep reserves much in excess of their legal requirements led to an unnecessary locking up of gold which was already scarce.

Secondly, the perfection of the central bank mechanism rendered the automatic working of the gold standard impossible. The central banks perfected the system of "open market operations" by which gold movements ceased to exercise any control over prices. When gold was imported into the country, it was sterilised by the sale of securities ; when it was exported, its effects were offset by the purchase of securities.

Thirdly, the existence of a large volume of international short-loan fund and its constant movements between different centres rendered the system of currency management very difficult.

Fourthly, the war debts and reparations put a heavy strain upon the debtor countries and the position was greatly complicated when these countries, unable to give gold, tried to create an export surplus (and to restrict their imports) by adopting protectionist tariffs.

Lastly, the post-war economic system was very rigid. If gold standard is to be properly worked, there must be a reasonable degree of elasticity in wages and other costs.

The Prospects and Conditions for the Restoration of the Gold Standard. World War II had completed the destruction of gold standard which had begun soon after the World Economic Depression and the important countries of the world found themselves entangled in the mass of inconvertible paper money. Fearing the gravest consequences to trade and finance arising from unstable money, they evolved an International Monetary Plan for the settlement of claims arising out of the day-to-day transactions after the War. The plan which has been finally approved at the Brettenwoods Conference provides for the fixation of the internal value of national currencies in an international unit. It aims at world prosperity and full employment all over the world—objects which were sought to be achieved by the old gold standard. This scheme can at best be temporary. Very soon the ghastly memories of the war will be forgotten and the ardour for world peace by international agreement will become damp. Every country will then have to carve out a system for itself and the claim of the gold standard is almost certain to receive careful consideration once again. It does not follow, however, that gold standard can be introduced by any one country independently of others or that it can thrive in an atmosphere of suspicion or distrust. On the contrary, the future gold standard will have to be based on some sort of international understanding and will perhaps require some sort of international organisa-

tion to work it. Hence as a preliminary to the restoration of the gold standard an atmosphere of goodwill and understanding will have to be created. The problems of war debts and reparations will have to be successfully solved and a way found for an even flow of international trade. In view of increasing scarcity of gold its use will have to be economised partly by replacing gold coins by tokens and partly by reducing the reserve requirements of banks. In order to release the pressure on gold reserves it may even be necessary to replace notes of smaller denominations by subsidiary coins because while notes must be backed by gold it is not necessary to provide a similar cover against token coins.

The Gold Exchange Standard. It may also happen that out of considerations of economy or for the purpose of maintaining a stable par of exchange, a country may have an inferior metal for local purposes and make gold (the international money) available for *foreign payment only* at an *approximately fixed rate.* Such a system is called a Gold Exchange Standard. Its theoretical advantages were first set forth by Ricardo when the bullion controversy was stirring Great Britain. A modified form of the system was used for regulating foreign exchange between Edinburgh and London in the second half of the eighteenth century. Holland appears to have been the first country to adopt it when, in 1877, she managed to keep her silver and paper currency at a fixed gold parity by selling foreign exchange at a fixed rate in terms of silver or paper. Although this Dutch scheme was subject to various stresses, it worked well. Russia followed by the adoption of the gold exchange standard in 1892 when the government agreed to sell exchange on Berlin at 2·20 marks per rouble and to buy at 2·18 marks per rouble. Austria-Hungary established a similar system during the same year. However, it remained for British India in 1893 to carry the scheme to a logical conclusion. The Government of India, between 1893 and 1917, used to give one pound for every 15 rupees tendered to them in India to enable Indian importers to pay for their goods in sterling in England; and, conversely, when foreign debtors wished to square up their debts in India, they had the option of delivering a pound sterling in England to get 15 rupees in India. During the period of monetary reconstruction following World War I a considerable extension of the gold exchange standard occurred. Countries that adopted some form of it included Austria, Poland, Germany, Chile, Ecuador, Colombia and Bolivia. But with the suspension of the gold standard in 1931, the gold exchange basis was simultaneously overthrown. The popularity of the Gold Exchange Standard is based upon the assumption that foreign exchange is as good as gold as cover for the national currency. The advantages claimed in favour of the Gold Exchange Standard have been nicely summed up by Conant as follows :—

1. It decreases the pressure upon the world supply of gold.
2. It helps the maintenance of a stable par of exchange between Oriental and Western countries.

3. It is admirably suited to poor and undeveloped countries ; and
4. It opens the market for silver and thus helps in steadying its value.[1]

It should, however, be remembered that the movement of foreign exchange from one country to another has by no means the same reaction on their price structures as the movement of gold. Under a gold standard, when gold leaves one country the prices fall whilst that of the receiving country expand to a like extent. In the case of the gold exchange standard, when the Central Bank purchases foreign exchange it increases the amount of its note-issue but at the same time there is no shrinkage in the credit structure of the country from which the foreign exchange is obtained. To put it more simply, because the gold does not go in and out, prices cannot easily be brought to an equality in all countries and fluctuations in exchange continue. Moreover, a gold exchange standard requires, for its successful working, a strong machinery for the purpose of maintaining an approximately fixed ratio of exchange between the internal currency and gold and sufficient reserves to back it up. Such a machinery may work successfully in normal times ; it may fail miserably when the world is torn apart by a war or by a severe economic depression. It is, therefore, obvious that the practical application of the gold exchange standard is subject to definite limitations under existing world conditions. These limits are largely set by the inability of mankind to settle disputes without resort to war or to prevent the recurrence of business depressions.

Sterling or Dollar Exchange Standard. If, however, instead of making the token currency convertible into gold, a country links it to sterling or dollar (or an independent currency of any other major country) the monetary system will be known after the name of the particular currency to which it is linked. Because the external value of the rupee is nowadays fixed in terms of the sterling, the present Indian currency system is called the Sterling Exchange Standard. It would be called the Dollar Exchange Standard if the exchange value of the rupee were fixed in terms of the dollar and not in terms of English currency. Like the Gold Exchange Standard, even this system depends for its proper working upon the type of the fund of exchange (reserves) and the form in which the fund is kept. It is generally unpopular because it is wrong in principle to link the destinies of the currency and prices of one country to the *fluctuating destinies* of any other currency however firmly linked to gold it may be. The following table shows very wide changes in the value of sterling in respect of dollar (gold) in recent years. It stands to reason that India, whose currency is linked to that of England, must

1 *Principles of Money and Banking,* Vol. I. pp. 392-403.

Also read Heilperin—*International Monetary Economics,* pp. 215-18 (and Kilborne and Woodworth—*Principles of Money and Banking,* pp. 50-51).

have suffered accordingly. The dates have been taken at random.

Date		Sterling—Dollar Exchange (Normal Par = £1 = $4·866)
April, 1931	...	4·851
September 24, 1931	...	3·82
March 10, 1932	...	3.98
August 10, 1932	...	3·48
December 1, 1932	...	3·19
January 1933	...	3·45
June 1933	...	4·11
November 24, 1933	...	5·20
December 14, 1933	...	5·01
August 17, 1934	...	5·09$\frac{3}{4}$
December 21, 1934	...	4·93$\frac{5}{8}$
March 10, 1935	...	4·85$\frac{3}{8}$

Paper Currency Standard or a Managed Currency System. The metallic standards are possible only when plenty of gold (or silver) is available but when the world is faced with a 'gold famine', as at present, the note-issue ceases to be legally convertible into precious metals. A system of paper money is usually the result of exceptional circumstances in which notes are no longer convertible and are granted *forced currency.* During the War, for example, gold was rare and was locked up by the creditor nations like America and the leading countries of Europe depended upon the printing press for providing them with the necessary sinews of war. In September 1931, England abandoned the gold standard and still continues to be on an inconvertible paper currency standard. Needless to say that the example of England has already been followed by several countries of Europe with the result that while countries which continued to stick to gold found it difficult to shake off the effects of the depression, countries adopting inconvertible currencies enjoyed a spell of prosperity. In any case the former took much longer time to recover from the crisis than the latter and the advocates of managed currency naturally received practical support for their views.

A currency system based on mere paper is generally very unpopular and would not be tolerated except in times of extreme national emergencies. "An inconvertible paper is viewed with uneasiness. People fear, and not without reason, that it will be issued in excess. Governments which have recourse to it are strongly tempted to escape the unpopularity of taxing the people by taxing them indirectly through the emission of more notes. It is so easy to get from a printing press any extra resources that are wanted urgently. As more inconvertible paper is put out beyond a certain amount it depreciates and as it depreciates public confidence in the currency is shaken and it depreciates still more."[1] The debtors gain at the expense of the

1 Chapman—*Outlines of Political Economy,* p. 245.

creditors and the people earning fixed incomes sustain unmerited losses.[1] "A government should, indeed, be in a desperate position which ventures thus to break all social contracts and relations which it was created to preserve."[2]

Another argument usually advanced against the paper standard is that, by causing uncertainty of prices, it checks internal and external business. It is also a favourite sport of currency speculators and a potent cause of dumping. It is true that exchange depreciation, which is possible under a managed currency system, stimulates trade but, like all stimulants, the immediate effects are pleasant, the after-effects very unpleasant indeed. The realisation of the disadvantages of competitive depreciation led the world only a few years ago, after the adoption of independent national monetary policies, to explore the possibilities of international co-operation.

Yet another essential characteristic of the paper standard is that the currency *circulates internally* and, therefore, the system does not provide a monetary basis in common with other national monetary systems. "Almost all monetary phenomena which require elucidation and almost all the problems which need solution in countries on a paper currency will be seen to derive from this essential characteristic.[3]

There are many drawbacks in the managed currency system. *Firstly*, it permits currency depreciation to become an instrument of national policy in the struggle for commercial advantages. A race for currency depreciation is started with disastrous consequences for the participants. *Secondly*, it seriously interferes with the free international movement of capital and trade and reduces the volume of world production. It checks international division of labour. *Thirdly*, political considerations may influence the working of managed currency system. It may be worked not to promote national prosperity but to promote the interests of the party in power. *Fourthly*, economic interdependence of different nations makes it impossible for any country to safeguard its internal economy from the effects of world economic dislocation even under managed currency system. *Fifthly*, the main argument that a managed currency secures stability of internal price level is of doubtful value since there is difference of opinion among economists regarding the desirability of stable prices. Hence, says Crowther, "The post-1931 managed currency system failed as completely as the gold standard. The nations have indeed been free to pursue internal policies of their own choosing, but the hundreds of thousands of unemployed in the export industries have been silent witnesses to the limitations of the scope for a purely internal policy, however well conceived and successfully executed. Fluctuating exchanges have not restored the nations' balances of

1 Revise Chapter VI—*Inflation and its Effects*.

2 Jevons—*Money and the Mechanism of Exchange*, p. 236.

3 Bertrand Nagaro—*Modern Monetary Systems*, p. 9.

payments to equilibrium and thereby removed the necessity for throttling restrictions on foreign trade."

Some enthusiasts of the paper standard, however, are of opinion that the defects of paper as standard of value have been grossly exaggerated. Prices in paper standard countries, they say, are by no means unstable or less stable than prices in gold standard countries, for gold prices have frequently moved upwards and downwards by over 20 per cent during the last few years. Regarding the argument that inconvertible paper allows spendthrift governments to print more money they point out that "if an irresponsible and reckless government does ever happen to get into power and run into debt it never hesitates, even under the gold standard, to abandon gold and print paper money. History supplies a long series of instances where even gold has not been an effective check at all."[1] Moreover, far from creating general instability, they say, exchange can be regulated more *effectively* and *automatically* under a paper standard than under any form of gold standard. "The beauty of the paper system," says Angas, "is that as soon as any disequilibrium between demand and supply occurs a sharp fluctuation in the price of foreign exchange *immediately* takes places, which, by its immediate action on both exports and imports rapidly restores equilibrium. The laws of supply and demand and price are thus allowed to operate freely and quickly —as theoretically they should in any market like that for foreign exchange, which is subjected to violent *short run fluctuations in both demand and supply*."[2] This argument may be valid if applied to a (theoretically perfect) international paper standard but certainly does not hold good in the case of those nations some of whom are on paper and others on gold standard for, as has already been pointed out, the fluctuations of exchange under the gold standard are *too small* to make any *appreciable* difference in the exports and imports. The exponents of the paper standard in minimising the dangers of inflation and artificial management for political purposes have obviously rested their case on the imperfections of the gold standard or on its mismanagement. It will, however, be admitted that ordinarily a gold standard is far superior to any paper standard managed in the usual way and that an ill-managed paper standard inflicts heavier losses on the people than can be conceived of under any form of gold standard.[3] Probably the best arrangement is a compromise between the two. Such a system will provide for stable exchanges during the short period, with conditions for movements from time to time. Such changes may be necessitated by the need for accommodating exchange rate to movements in internal price level. The

1 Angas—*The Problems of the Foreign Exchange*, p. 155.

2 *Ibid*, p. 62.

3 "Fiat paper has been well called the alcohol of commerce whose fumes entering the brains of individuals and of government officers, seem to make them incapable of sober judgment or self-restraint in the matter of further issue and further demoralisation takes place." Kinley—*Money*, p. 351.

International Monetary Fund is an institution designed to give a practical shape to this ideal. It is an international version of the Exchange Equalisation Funds and of the International Tripartite Monetary Agreement which supplanted the Gold Standard.

Essentials of a Good Monetary System. From what has been said above it would appear that the selection of a monetary standard should neither be *arbitrary* nor *sentimental.* Although the system of each country will depend upon its own social and economic requirements, an ideal standard should satisfy the following conditions :—

1. It should stabilize currency, prices and exchange both within the country and outside.
2. It should economise the use of precious metals.
3. It should be elastic, that is, capable of expansion and contraction in response to the requirements of trade.
4. It should command the confidence of the people.[1]

It does not mean, however, that the stability of prices or exchange should be our main goal. A modern state is essentially a welfare state. It aims at the highest possible welfare for the greatest number over a period of time. This can be done by adopting an economic policy which will ensure a high level of production, stable employment, equitable distribution of the national income, and a rising standard of living. Hence, the monetary management should be such that the economic goals tending to maximum economic welfare are realised as nearly and as quickly as possible.

SUMMARY

The stability of currency and prices in a country can be secured by adopting a suitable coin or combination of coins as standard of value. If two standard coins circulate side by side the monetary system is called bi-metallism but if the values of all other coins are adjusted in terms of one standard coin it is called mono-metallism.

Bi-metallism and Gresham's Law. Under bi-metallism both the standard coins are freely minted and are unlimited legal tender and the value of one in terms of the other is rigidly fixed. This system is advocated on the ground that changes in the value of either currency are automatically set right by a sort of compensatory action between them and because it helps in maintaining a stable par of exchange both with gold and silver using countries. It also keeps prices up and thus helps production. But the system does not work well owing to the operation of Gresham's Law according to which the cheap currency drives the dear one out of circulation. This law applies to all kinds of money and in each case the bad money tends to drive the good one out of circulation except when the supply of money is less than, or just equal to, demand or when the public opinion is opposed to the acceptance of bad coins. In the case of bi-metallism, silver, a cheap metal, throws gold very much into the back-ground.

Limping Bi-metallism. It is an imperfect form of bi-metallism under which two metals are unlimited legal tender but only one (the dearer one) has got

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1 "The main need of the world today......is more confidence. There can be no surer route to the re-establishment of confidence than the stabilisation of exchanges"—L. Robbins, "Paper Systems" an article in the *Gold* (Times Publishing Co.), p. 46.

free coinage. It comes into existence when there is danger of the cheap metal expelling the dear one out of circulation.

Parallel Standard. In it there are two standard coins in circulation but the value between them is not fixed. They circulate at their bullion value from day to day. It was introduced in England in 1663 but was given up as being obviously inconvenient and speculative.

Mono-metallism. It may exist in the form of gold or silver standard—the latter being more suitable to poor and less civilised countries.

The Gold Standard. It has always been popular with the people owing to the utility and intrinsic merits of gold and because countries adopting it can hope to enter into relations of stable exchange with the richer countries, especially England. Before the war the gold standard was regarded as absolutely identical with the gold currency standard but now economists do not attach any great importance to the circulation of gold coins. According to the post-war conceptions, therefore, a gold standard can exist even if the token currency is made legally convertible into a gold bar of fixed weight and fineness at all times and for all purposes. This latest modification of the gold standard is called the Gold Bullion Standard. It is supposed to be as effective in the working as the gold currency standard and has the additional advantage of economising the use of precious metals. People have, however, expressed grave doubts about its successful working.

Difficulties of Working the Gold Standard after World War I. The gold standard introduced in 1925 failed partly owing to the increase in the reserve requirements of banks and partly owing to the action of the central banks in controlling and regulating the effects of gold movements. The presence of short loan fund and the adoption of protectionist policies also made its retention impossible.

The Prospects and Conditions of the Restoration of the Gold Standard. In view of the scarcity and unequal distribution of gold the present-day economists are attempting to avert the disasters of inconvertible paper money by evolving an International Currency Plan. Such a Plan will, however, be short-lived and sooner or later the world will have to think again of the gold standard. Such a system, if and when it comes, will pre-suppose international agreement and a complete solution of the major political and economic problems of the world[1].

The Gold Exchange Standard. Under it there are two currencies—a token currency for internal purposes and an external currency for foreign payments only and the value of one in terms of the other (for foreign transactions only) is approximately fixed. The system permits economy in the use of gold and is particularly suited to poor and undeveloped countries but is not viewed with favour partly because it makes the currency of one country dependent upon the currency of another and partly because it does not influence the price-levels. It also requires an elaborate machinery for regulating exchange and rich specie reserves.

Sterling or Dollar Exchange Standard. If the currency of one country is linked to the currency of another the monetary standard is known after their respective standard money. For example, the Indian system would be called the Rupee-Sterling or Rupee-Dollar Exchange standard according as it is linked to the currency of England or U.S.A. respectively. Such a system is generally harmful because it makes the currency and prices of one country dependent upon the fate of the currency system of the other however firmly linked to gold the latter may be.

Inconvertible Paper Currency Standard. It is introduced in extreme national emergencies like big wars when the government cannot afford to manufacture metallic money. It should not be adopted for a single day more than it is required because there is a grave apprehension of over-issue and consequent depreciation of currency with its attendant evils.

Essentials of a Good Monetary System.

1. It should stabilise currency, prices and exchange.
2. It should economise the use of gold.

1 It has now been introduced as International Monetary Fund—See pp. 124.

3. It should be elastic.

4. It should inspire public confidence.

5. It should be so integrated with the general economic policy of the country as to ensure high level of production, stable employment, equitable distribution of the national income and a rising standard of living. In short, it should aim at maximum economic welfare.

QUESTIONS

1. Explain what is meant by 'monetary standard.' By what name is the monetary standard obtaining in India called and why ? Show how it functions. [U. P. Inter. 1934]

2. What is bi-metallism ? Describe its chief advantages and disadvantages. [Calcutta B. A. 1925]

3. Indicate the characteristics of bi-metallism and contrast it with a mono-metallic standard on one side and a parallel standard on the other.

4. Comment on the statement, "Bad money drives good money out of circulation."

5. What are the essential characteristics of a gold standard ? In what respects does the gold standard at the present time differ from that which existed in pre-war days ?

6. To what extent does the existence of a gold standard guarantee the stability of prices ?

7. "The gold standard is in its essence an abstract standard where the price of gold is fixed not absolutely but so far that variations of the price are restricted within very narrow limits." Explain this and bring out clearly the contrast between the Gold Exchange Standard and the Gold Bullion Standard. [Delhi B. A. 1932 : Agra B. A. 1932]

8. In what different ways is it possible to combine gold and silver in the currency system of a country ? [Calcutta B. A. 1931]

9. Criticise the suggestion that the use of gold as a medium of exchange involves corresponding loss of national wealth which might be saved by replacing the metal by tokens.

10. Write brief explanatory notes on :—

(*a*) Gresham's Law.

(*b*) Law of Compensatory Action.

(*c*) Sterling Exchange Standard.

(*d*) Limping Bi-metallism.

11. Explain the circumstances leading to the creation of the International Monetary Fund and point out the advantages and disadvantages to India of joining this scheme. [Delhi M. A. 1948]

12. Discuss the need for and the prospects of an International Gold Standard in the near future.

CHAPTER X

THE INDIAN CURRENCY SYSTEM

THE PRE-WAR PERIOD

We are now in a position to study the historical evolution of the Indian currency system a little more in detail and to discuss the position of the rupee in each period.

Before 1835.[1] A great variety of gold and silver coins circulated in different parts of the country—silver rupees being used chiefly as standard money while the value of gold coins usually depended upon the market price of gold. Much inconvenience was caused by the circulation of so many gold and silver coins[2] of different values and denominations with the result that by the Act of 1835 (No. XVII) silver rupees of 180 grains 11/12th fine (that is, containing 165 grains of pure silver and 15 grains of alloy) were made standard coins for the whole of the East India Company's dominions in India. Gold coins were deprived of their legal tender qualification although mohurs of the same weight and fineness as the rupee continued to be minted in large amounts on Government account and circulated at their bullion value.

1835-1873. The Silver Standard. Thus was introduced a universal and an automatic silver standard. Mints were open to the free coinage of silver when offered in sums of not less than 100 tolas. The coinage charges were 2 per cent for silver 11/12th fine in addition to 1 per cent for melting. The new rupees were unlimited legal tender throughout the length and breadth of British India. The exchange value of the rupee depended on the fall or rise in the value of silver. No ratio between gold and silver was fixed. It alternated according to the variations in the prices of gold and silver. Attempts were made to introduce a gold currency standard especially after 1866 when the Mansfield Commission suggested the advisability of a legal tender of gold being made a part of the currency arrangements of India but they failed especially owing to a heavy decline in the gold price of silver, caused by its demonetisation by Germany and the Latin Union,[3] and its over-production.

1 Those who desire to study the history of this period in detail will be well advised to read Robert Chalmers' *A History of Currency in the British Colonies*, pp. 336-41 and Sir Jadunath Sarkar's *Economics of British India* (4th Edn. 1917).

2 A Bengal regulation of 1793 mentions no less than 17 varieties of rupees as current in the several districts. Also read Macleod, *Indian Currency*, p. 13.

For a still more detailed account read J. C. Sinha—*Indian Currency Problems in the Last Decade*, pp. 3-7.

3 Comprising France, Belgium, Switzerland and Italy.

1873-1893. Breakdown of the Silver Standard. The price of silver started falling in 1873 and by 1893 had fallen by about 4 per cent.[1] The rate of exchange (with gold) fell from 20·5d. in 1880 to 14·9d. per rupee in 1893 as the following table will show :—

Year					Average price of silver per ounce (in Pence)	Average rate of exchange (in pence per rupee)
Average of 5 years ending				1880	53	20·530
,,	,,	,,	,,	1885	51	19·644
,,	,,	,,	,,	1890	44	17·108
,,	March 31		,,	1891	47	18·089
,,	,,	,,	,,	1892	45	16·733
,,	,,	,,	,,	1893	39	14·984

This had obviously serious consequences. People purchased cheap silver and presented it to the mints for being coined into rupees. The amount of money in circulation increased accompanied by an inevitable increase in prices. The import trade suffered as well as those British officials who received salary in rupees but who remitted a part of it to England because they could now send only fewer sovereigns than before. It imposed *heavy financial burdens*[2] on the Government of India which had to remit more Indian money in payment of Home Charges. The wage-earners also suffered owing to rise of prices.

The Government tried various alternatives and ultimately referred the whole question to the Herschell Commission in 1893. The recommendations of this commission were embodied in the Coinage Act of 1893. This Act provided for the immediate closing of the Indian mints to the free coinage of silver with the proviso that the Indian Government should retain power to coin silver on their own account. Three administrative Notifications were also issued—the *first* provided for giving rupees in exchange for gold presented at the

1 It will be interesting to note that although this period is characterised by fall of price there was actually a rise between 1890 and 1892. The reason was that under the provisions of the Sherman Silver Purchase Act of 1890 the United States were compelled to buy 4,500,000 ounces of silver every month in payment for which they issued "treasury notes." "These purchases for a time artificially buoyed up the price of silver but the accumulation of silver was becoming dangerously large and the silver market was in a precarious condition because of the agitation for the repeal of this Act and the further danger that much of this accumulated silver might be upon the market."

2 "To make this point clearer, it may be mentioned that in 1873-74 before the fall in the exchange value of the rupee commenced, the amount of Home remittance in lieu of payments the Secretary of State makes in England on behalf of the Indian Government, for such charges as interest on debt raised in England, civil and military pensions, salaries, the price of stores etc., was about £13 millions which at a rate of exchange of 1s. 10·35d. was represented by Rs. 14,26,57,000. During 1892-93 the amount remitted was £16½ millions which at the average rate of exchange in this year *viz*, 1s. 2·985d. required payment of Rs. 26,47,84,150. If this had been remitted at the rate of the exchange of the year 1873-74, it would have needed only Rs. 17,75,19,200, which means that there was a loss of Rs. 8,72,64,950 entailed upon India by the fall of exchange in that year." Kale—*Gokhale and Economic Reforms*, p. 28.

Indian Mints at the rate of 16d. to the rupee ; the *second* authorised the receipt of sovereigns and half sovereigns by the Government in payment of taxes and other Government dues at the same rate and the *third* provided for the issue of currency notes in exchange for British coin or gold bullion at the corresponding rate. "The objects were to arrest the fall in the exchange value of the rupee, to encourage the import of foreign capital, to familiarise the people with the use of gold sovereign and, finally, to discourage the imports of silver." The rate of 16d. was chosen partly because it was in the neighbourhood of the average exchange rate of the previous two and a half years and partly because at this rate a sovereign would be the equivalent of fifteen rupees, the rate at which the gold mohur, which was demonetised in 1835, exchanged for rupees. The rupees, moreover, contain sixteen annas and one penny was thus the equivalent of one anna.

1893-1898. The change proved to be very beneficial. "Down to June, 1893—the month in which the mints were closed—the bullion value of the rupee and the exchange value moved continually together but from that date forward the close parallelism in the movements of the two values ceased. It was no longer possible to have bullion transformed into rupees by the payment of a small brassage charge whenever the gold value of the rupee rose above the gold value of 180 grains of silver, 11-12th fine." By thus controlling the minting of rupees and by giving it an arbitrary value the Government could control its quantity and value. The currency was starved and prices fell till in January, 1898 the rupee touched 1s. 4d.

The following table based on the statistics supplied by Mr. Atkinson, the then Accountant General of the United Provinces, gives an idea of the course of prices during the 13 years—1887-1899.

Year	Index No. of Prices	Year	Index No. of Prices	Year	Index No. of Prices
1887	101	1892	128	1897	149
1888	108	1893	125	1898	122
1889	114	1894	119	1899	127
1890	114	1895	116		
1891	116	1896	127		

It will be noticed that whereas during the six years preceding the closing of the mints prices rose from 101 to 123, they actually fell after 1893 except in 1896 and 1897 when, owing to a severe famine, the prices of food and grain rose much above expectations. The Government appointed another Committee, presided over by Sir Henry Fowler, in 1898 to review the changes brought about in the Indian currency system between 1893 and 1898 and to suggest "active measures to secure the stability of exchange which was the main

object of the policy adopted in June 1893." The main recommendations of the Fowler Committee were that the sovereigns should be declared legal tender throughout British India at Rs. 15 per sovereign and that a gold standard with its natural accompaniment of gold currency should be established. The Committee also recommended that the Indian mints should continue to be closed to the unrestricted coinage of silver and should be opened to the unrestricted coinage of gold. Fresh rupees should not be coined until absolutely necessary and that any profit on the coinage of rupees should be kept in gold as a special reserve apart from the paper currency reserve. The new reserve, called the Gold Standard Reserve, was to be used for maintaining the exchange value of the rupee.

The Government of India accepted these recommendations. Sovereigns were declared legal tender, the Gold Standard Reserve was instituted and arrangements were made for the coinage of gold in India.[1]

1898-1914. The Gold Exchange Standard. The scheme of establishing a gold currency standard, however, did not succeed owing partly to our traditional associations with the rupee, partly to the operation of the Gresham's Law but mostly due to our transactions being of small value.[2] Moreover, the nine years[3] following the Fowler Committee were years of good harvests and all round business prosperity. There was a great demand for money in circulation and people were anxious to purchase rupees (and currency notes) for gold which was incidentally depreciating in value all over the world chiefly as a result of large gold production in South Africa. The Government were, therefore, literally "swamped (temporarily) by gold" and gold coins were gradually driven away from circulation. The coinage of rupees had to be resumed in 1900 and a part of the Paper Currency Reserve was transferred, temporarily in 1898 and permanently in 1902, to London for the purchase of silver required for minting fresh rupees. The Government at last withdrew its offer to convert token currency into gold for internal purposes. It merely undertook to exchange rupees for sovereigns for *external purposes only*. The plan worked like this. Whenever the balance of trade was favourable and the British importers wished to remit money to India, the Secretary of State accepted the payment (at rates representing India's gold import point *viz.*, 1s. 4⅛d.) and issued a writ (Council Bill) requesting the Government of India to pay the equivalent in Indian currency out of the Paper Currency Reserve. The receipt in England went to strengthen the Paper Currency Reserve in England while the same amount of currency was added to circulation in India. For some time this expedient was adopted only when the Secretary of State wanted to get money in respect of Home Charges but in 1904 the

1 The scheme was, however, dropped when nearly complete in 1902.

2 Some people have also ascribed it to the opposition of the British Treasury. See *Industry Year Book and Directory*, 1933, page 82.

3 Except 1907-8 when a disastrous famine and plague overtook the country.

Secretary of State announced his willingness to sell Council Bills in unlimited amounts at the rate of 1s. 4½d. The practice was continued up to 1907 when India was again visited by a disastrous famine. The balance of trade became unfavourable and the exchange tended to go below the gold export point (1s. 3·29/32d.) The Government met the situation partly by stopping the sale of Council Bills in England and partly by offering to remit money to England on behalf of the Indian importer at the lower specie point by means of bills drawn on the Secretary of State called the Reverse Council Bills. The crisis was over before the close of 1908 but not without leaving a deep impression upon the Indian currency system. Henceforth the Indian currency could be contracted as well as expanded by the draft selling mechanism and the gold value of the rupee could thereby be maintained between the gold points.

Thus was established the Gold Exchange Standard or, as some people choose to call it, the Sterling Exchange Standard.[1] On account of the severe criticism of the currency and exchange policy of the Government, especially on the part of those who wanted a full-fledged gold currency standard, a Royal Commission on Indian Currency and Exchange called the Chamberlain Commission, was appointed in 1913. The Committee supported the measures adopted by the Government for maintaining the exchange value of the rupee. They were definitely of the opinion that the gold exchange standard was not only workable, but, in the absence of any developed banking system, was admirably suited to the country on account of its cheapness. In view of the fact that heavy imports of gold from Australia and Africa had lately found their way either into the reserves or into ornaments and hoards, they considered a gold currency standard of the type contemplated by the Fowler Committee as absolutely *undesirable*. They saw no objection, however, *in principle*, to the minting in India of sovereigns and half-sovereigns if Indian sentiment genuinely demanded it and the Government of India were prepared to incur the expense. The main recommendations of the Committee obviously lacked appreciation of the wishes of the people who had, since the crisis of 1907-8, been pressing for the increasing use of gold in circulation. Among the minor alterations proposed were the prompt selling of Reverse Council Bills and the abolition of the silver branch of the Gold Standard Reserve. The need for maintaining adequate reserve of gold and sterling securities in London for the purpose of converting internal currency into international or external currency was also emphasised.

To sum up, the pre-War currency system of India had the following features[2] :—

1. The internal currency consisted of the rupee, which, although a token coin, also served as a standard of value, the notes

1 See L. C. Jain—*The Monetary Problems of India*, p. 10.

2 Also see Keynes—*Indian Currency and Finance*, pp. 6-7.

(also the monopoly of the Government) and small subsidiary coins which were legal tender up to Re. 1 only.

2. The British sovereigns, which were not legal tender, provided means for external payment.

3. The rupee, though unlimited legal tender, was convertible into gold only for exchange purposes at the rate of Rs. 15 for a sovereign (16d. to a rupee).

4. The sterling (gold) value of the rupee was regulated between 1*s*. 4⅛*d*. (the upper specie point) and 1*s*. 3.29/32*d*. (the lower specie point) through the sale of council bills and reverse council bills respectively.

5. With a view to working this system of regulating the value of the rupee, the Government maintained two reserves—the one mainly in rupees in India, the other in sterling in London. The Indian reserve consisted of the Indian portion of the Paper Currency Reserve, the Gold Standard Reserve and Treasury balances while the reserve in England included the London branches of the Paper Currency and Gold Standard Reserves and the balances of the Secretary of State. Although each of these reserves had been created for a specific object, they were both available in case of need for the general object of supporting exchange and thus constituted practically one single fund.

A careful reflection will show that under this system of Gold Exchange Standard the rupee occupied a peculiar position. It was a token coin in so far as its face value was much higher than its intrinsic value and it also served as a standard coin for all practical purposes. It has, therefore, been called a '*Standard Token Coin.*' Moreover, the position of the rupee was identical with that of the note. Both could be used for buying and selling, for borrowing and lending and for paying taxes to the Government but neither of them was convertible into gold. There was, however, a slight difference in their merits, for while the note was worth nothing, the rupee was, at any rate, worth the silver contained in it. It is, therefore, also true to say that the rupee was practically in the position of an inconvertible note with the only difference that while one was printed on silver the other was printed on paper.

SUMMARY

Before 1835, a large variety of gold and silver coins of different denominations were current in different provinces and caused great inconvenience to trade and industry. The Act of 1835 introduced a full-fledged silver standard for the whole of British India. The mints were thrown open for the free coinage of rupees which contained 180 grains of silver 11/12th fine. The system worked successfully until 1874 when the price of silver began to decline. Cheap silver was offered to the Government for being minted into rupees and the prices began to rise. Considering the losses sustained by people earning fixed incomes and the Government, the Herchell Commission was appointed in 1893 and, acting on its recommendations, the mints were closed to the free coinage of rupees. The exchange value of the rupee in terms of the British sovereign was fixed at Rs. 15 to a sovereign.

The change proved successful. Prices and exchange came back to the normal and the Government appointed the Fowler Commission in 1898 to suggest changes

in the then existing limping currency system. The Commission suggested a gold currency standard with sovereigns as standard coins and convertible into rupees at 1s. 4d. to a rupee. The coinage of rupees was to be resumed on Government account only and the profit was to be carried over to a special reserve called the Gold Standard Reserve. The scheme of gold currency, however, did not materialise owing to the poverty of the people who showed marked preference for silver. A part of the Paper Currency Reserve was transferred to England to enable the Government to purchase more silver for minting rupees and the Government undertook to sell Council Bills for the purpose of enabling the British importers to pay their debts in India and Reverse Council Bills for the purpose of enabling the Indian importers to pay for their goods in England without having to remit specie. This system, which was thoroughly approved by the Chamberlain Commission in 1913, is called the Gold Exchange Standard or more appropriately, the Sterling Exchange Standard because payments were actually made in sterling and not in gold. The position of the rupee under this system was peculiar. It was a token coin and yet for all practical purposes the standard coin of the country. It has, therefore, been called a 'Standard Token Coin.' For internal purposes the rupee was not convertible into gold. It has, therefore, sometimes been compared to the paper note which was also inconvertible and which differed from the rupee only because it possessed no intrinsic value. Hence the remark that, before the War, "the rupee was in the position of an inconvertible note printed on silver."

QUESTIONS

1. Explain the circumstances leading to the appointment of the Herschell Commission. What changes in the monetary system of India did it suggest and what were the results of those changes ?

2. Why and how was the Gold Exchange Standard established in India ?
[Delhi Inter. 1932]

3. What part did gold play in the Indian Currency system before the War ?
[Delhi Inter. 1931]

CHAPTER XI

THE INDIAN CURRENCY SYSTEM—*(Continued)*

THE WAR PERIOD

World War I began in 1914. In addition to the heavy toll of human life which it claimed, it will also be remembered as a serious calamity which destroyed normal trade and commerce and threw the world exchanges into utter confusion. The countries actively engaged in War and their allies diverted their labour and capital to the manufacture of war material and allowed other essential articles to be imported from outside. The precious metals being scarce, many countries abandoned the gold standard and even those that stuck to it imposed heavy restrictions against the melting or export of gold without the permission of the government. To provide the governments with additional sinews of war huge amounts of inconvertible notes were put into circulation with the result that depreciated currencies and steeply rising prices became the order of the day especially in the belligerent countries. The case of India was slightly different. Although as a member of the British Empire she shouldered her full share of responsibility, her anxiety was not quite as great as that of many other countries. Let us study the course of events in India during the different phases of the War.

1914-15. As soon as the War broke out the people were panic-stricken. Not being quite sure of the direction in which the wind might blow, a majority of them demanded the encashment of notes into gold and the return of their Savings Bank deposits. The trade was abruptly thrown out of gear[1] and exchange showed signs of weakness. Fortunately, the Government soon succeeded in restoring public confidence by providing adequate facilities for the encashment of notes and for withdrawal of notes and for withdrawal of deposits from the Savings Banks. Reverse Council Bills to the extent of £9,000,000 were sold in support of exchange which became fairly steady between 1915-16. It was also arranged that bills should be payable in London sixteen days after the departure of the weekly mail. The uncertainty of the delivery of the bills in London was by this means eliminated.

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1 The heavy fall in the balance of trade can be seen from the following table :—

Year	Net exports (in thousands of £)	Year	Net exports (in thousands of £)
1909-10	... 47,213	1914-15	... 29,108
1910-11	... 53,615	1915-16	... 44,026
1911-12	... 59,511	1916-17	... 60,843
1912-13	... 57 020	1917-18	... 61,402
1913-14	... 43,753	1918-19	... 56,540

1915-18. The effect of the war conditions, however, began to be seriously felt in 1916. There was a marked reduction in imports due to the shortage of shipping and England's pre-occupation in the production of war material. The value of exports, on the other hand, increased owing to the shipment of large quantities of food and raw materials to the Allies thus making the balance of trade overwhelmingly favourable to India. The combined effect of these factors was to create a heavy demand for Indian currency which was all the more accelerated by the enormous payments which the Government of India had to make on behalf of His Majesty's Government. This demand was partially met by the extensive coinage of rupees[1] and by the increase of note-issue without the usual metallic backing. The fiduciary portion of the reserve was increased from Rs. 20 crores to Rs. 120 crores and new notes of Re. 1 and Rs. 2½ were put into circulation[2]. Nickel coins of denominations of 2 annas, 4 annas and 8 annas were issued in order to economise the use of silver. But, just at this time when the Government of India were pooling their resources to tide over monetary stringency, there came an unprecedented rise in the price of silver. Due partly to the increased cost of production and comparative shortage of supply but mostly to an unusually keen demand for it all over the world the price of silver rose from 27d. an ounce in 1915 to 43d. in 1917—a price at which the exchange value of the rupee at 1s. 4d. was equivalent to its bullion value.[3] In September 1917 the price rose to 55d. per ounce and to 78d. in December 1919. Obviously, it became profitable for the people to melt rupees and to sell them as bullion.[4] Gold also suffered the same fate. Owing to keen demand, especially at a time when its production was seriously curtailed, its price went up too. All the available gold of the world found its way into the neutral countries and financing Allies leaving practically nothing for the fighting countries to put in the reserves as backing for note-issue. In view of the shortage of the precious metals, an Ordinance was promulgated on June 29, 1917 requiring all gold imported into India to be sold to the Government at a price based on the sterling exchange value of the Indian rupee. The gold thus acquired was put in the reserve as a backing for the issue of additional notes. A branch of the Royal Mint was opened in Bombay in August 1918 where 2,950,000 gold mohurs and 1,295,000 sovereigns were coined. The melting of silver was strictly prohibited.

The exchange standard of India before the War depended for its success upon Government's ability to maintain an *artificial* value of the rupee and to prevent it from rising above or falling below fixed rates. The legal ratio between the rupee and sterling was

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1 With the help of 300 million ounces of silver purchased in the market and 200 million ounces placed by the U. S. A. at the disposal of the Government.

2 Also see Chapter XIII.

3 See p. 67, *supra*.

4 Notwithstanding its prohibition by law.

normally kept steady by means of an *adequate* supply of internal and external currencies and reserves according to the requirements of trade. On account of the extraordinary conditions mentioned above the Government found it impossible to work the system in the normal way. The weekly sale of Council Bills was restricted to about Rs. 120 lakhs at a price rising with the sterling value of silver. The exchange rose to 1s. 5d. in 1917, touched 2s. 4d. in December 1919 and the monetary system, which had worked so successfully before the War, failed.[1]

It has already been mentioned that, in the absence of gold and silver, the Government had perforce to issue notes in huge quantities without providing the necessary metallic cover.[2] The currency was, therefore, almost on the verge of inconvertibility and its fate hung continuously in the balance. Thanks to India's position as a financing ally the purchasing power of her currency instead of going down actually went so far up as to be almost double the pre-War parity. But for this privilege the value of her notes would have been reduced to less than that of the paper on which they were printed (as in Germany).

SUMMARY

The destructive War of 1914 shook the currency system of the world to their foundations. The main difficulties were caused by the stoppage of production on one side and drastic inflation of currency on the other. India suffered in common with other countries.

During the first year of War (1914-15) the people in India were panic-stricken. They rushed to the Postal Savings Banks to withdraw their deposits and presented their notes to the Government for being converted into gold. The balance of trade became less favourable than before. The Government faced the situation very boldly and public fears were set at rest within a short time.

From 1915 onwards, the imports of India declined whilst her exports increased enormously. The demand for India's currency abroad increased but more rupees could not be minted owing to an unprecedented rise in the price of silver. Nor was gold available either for coinage or for providing metallic cover for note-issue. The dealings in precious metals on private account were prohibited as also the melting of rupees. In view of the scarcity of currency the sale of Council Bills in England was *restricted* to about 120 lakhs a week and they were sold not at the pre-War rate of exchange but at prices varying with the price of silver. More currency was created by raising the limit of the fiduciary portion from Rs. 20 crores to Rs. 120 crores and by issuing new notes of Re. 1 and Rs. 2½. It will be observed that the pre-War gold exchange standard which required the maintenance of a fixed rate of exchange completely broke down during the War when the Government *refused to sell Council Bills up to unlimited amounts and at fixed rates* and when the exchange was allowed to rise from 1s. 4d. in 1914 to 2s. 4d. in 1919.

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1 The following table shows the rapid increase in the rate of exchange between 1917-1919 especially towards the concluding year of the War :—

January, 1917	... 1s. 4½d.	August, 1919	... 1s. 10d.
August, 1917	... 1s. 5d.	September, 1919	... 2s. 0d.
April, 1918	... 1s. 6d.	November, 1919	... 2s. 2d.
May, 1919	... 1s. 6d.	December, 1919	... 2s. 4d.

2 Percentage of metallic backing decreased from 78 per cent in 1914 to 35 per cent in 1919.

QUESTIONS

1. Account for the breakdown of foreign exchanges in almost all countries of the world, including India, during the time of the Great War (1914-18).
[Delhi Inter., 1931]

2. Describe the difficulties experienced in the management of Indian currency and exchange during the War period. [Delhi Inter. 1928 and 1932]

3. Account for the violent fluctuations in the rupee-sterling exchange during the last Great War.

CHAPTER XII

THE INDIAN CURRENCY SYSTEM—(*Continued*)

THE POST-WAR PERIOD

1919-1926. The Babington Smith Committee. On the termination of War the review of the Indian currency was entrusted to the Babington Smith Committee in May 1919. The Commission were inclined to suggest a gold currency standard but, in view of the great scarcity of precious metals, they recommended the re-introduction of the gold exchange standard with a genuine warning that should public opinion express itself in favour of the circulation of gold coins, the demand should be ungrudingly conceded. In view of the phenomenal rise of exchange during the War, they further recommended that the sovereign should be made legal tender in India at the revised ratio of Rs. 10 to one sovereign (Re. 1=2s)[1], although the notification of the Government undertaking to give rupees for sovereigns should be withdrawn. The high ratio was recommended because the Commission believed that the price of silver would continue to be high and that if the exchange value of the rupee was fixed at 2s. the rupee would be once more established as a token coin and it would be possible for the Government to control and regulate the amount of currency in circulation. It was also preferred to the pre-War parity (1s. 4d.) because the latter was expected to raise prices and entail great hardship on the poorer classes. It was regarded as advantageous to Indian producers as it would keep down the cost of imported materials and machinery in rupees and would keep wages down. The fear that exports would be discouraged was not regarded valid because, owing to the world shortage of raw materials and foodstuffs, the demand for Indian products abroad was very great. The Government finances were to gain enormously from the high level of exchange because it was calculated that there would be a saving of more than Rs. 12 crores in the remittance of Home Charges.

Among other recommendations of the Committee the following deserve special mention :

(1) A gold mint should be opened in Bombay for the coinage

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1 The rupee was thus made equal to 11·30016 grains of fine gold. Since dollar then was the only coin made of gold, this sytem has sometimes, erroneously, been called the Dollar Exchange Standard.

It must be emphasised that the rupee was linked to *gold* and not to the pound sterling. Gold coin was not in circulation in England and Treasury notes formed the great bulk of the full legal tender currency and were not convertible into gold. The pound sterling was, therefore, at a discount and 2s. gold was equal to about 3s. sterling. Also read Kale—*Indian Economics*, p. 543, foot-note.

into sovereigns of gold tendered by the public.

(2) The import and export of gold should be freed from Government control as soon as the change in the statutory rate to Rs. 10 per sovereign had been effected.

(3) The prohibition of private import and export of silver should be removed.

(4) The Gold Standard Reserve should contain a considerable proportion of gold and the remainder should consist of securities issued by Governments within the British Empire, other than the Government of India, and maturing within 12 months. Fifty per cent of the Gold Reserve was to be held in India.

The Government accepted most of these recommendations and removed all war-time restrictions. They instructed the treasuries and currency offices to accept sovereigns and half-sovereigns at the rate of Rs. 10 and Rs. 5 respectively but not to issue them. As the market price of the sovereign continued to be above Rs. 10 it never functioned as currency at the new ratio. The gold mint was not opened either.

The Fate of 2s. Rate. The problem of ratio also proved elusive. Gold was then selling at Rs. 22¼ per tola whereas according to new ratio the price of gold ought to have been Rs. 15-14-0. In view of such a great disparity it was clearly difficult, if not impossible, to maintain the ratio of 2s. gold. Moreover, the balance of trade and prices which were so favourable during the War, became equally unfavourable after 1919. "Imports had increased owing partly to the stimulating effect of the rise in exchange on demand. Exports, on the other hand, had declined owing to a combination of adverse circumstances. In the first place, Japan, one of the chief buyers of Indian cotton was obliged to reduce her purchases because of a financial crisis there. Secondly, the demand for jute, hides and tea fell off partly because of the large stocks accumulated in England and elsewhere and partly because of the industrial uncertainty prevalent in the markets for these goods. Thirdly, India lost some of her best customers. Owing to various economic and political troubles, the countries of Central Europe were not then in a position to pay for what they wished to purchase."[1] The result was that while in August 1919 the balance of trade was favourable to the extent of 11 crores of rupees in August 1920 it was unfavourable by about the same amount. Similarly, although the prices had started falling they were falling faster in U.S.A. and still faster in England with the result that while the value of the rupee in terms of gold fell, it fell all the more in respect of the sterling. The post-War boom came suddenly to a close. Advantage was taken of the high exchange by the European community to remit to England the great profits which it had made during the War. Indian importers who would ordinarily have waited for months to make remittances to England hastened to do so to avail

1 Chablani—*Indian Currency and Exchange*, p. 92.

of the favourable rate. There was a regular speculation in exchange. Those who were convinced that the exchange would fall found it easy to make profits by first converting rupees into sterling at the high rate and then turning sterling back into rupees when the exchange came down. Such a heavy demand for sterling caused the value of the rupee (in respect of sterling) to fall. The exchange could not be maintained at 2s. gold (which at the time meant nearly 3s. sterling) although the Government offered to sell Reverse Council Bills[1] to an unlimited extent. When the attempt to hold the exchange at 2s. gold failed, efforts were made to hold it at 2s. sterling. But these also failed. Between 1919 and 1922, Reverse Councils to the extent of £55·5 millions were sold to no avail till at last the Government admitted their inability to maintain exchange at any rate. In 1922 they refused to sell any more sterling drafts on London. "The collapse of exchange within twelve months from the level of 2s. 4d. prevailing in April 1920 to below 1s. 3d. was critical for importers many of whom had ordered goods when exchange was high without fixing their exchange and who were unable or unwilling to settle at the low rate prevailing when the goods arrived. At the close of the year the Indian ports remained congested with imported piece-goods, motor cars and other articles of which delivery had not been taken. In further contrast to the preceding year there has been an almost continuous return of rupees from circulation, a symptom of the general stagnation of trade."[2]

Before 1922-25, therefore, there was theoretically no standard although the Government, helped by the revival of trade, succeeded in linking the rupee to sterling at 1s. 6d. to a rupee. In the meanwhile aroused by the serious harm done to trade by frequent changes in the monetary standard, the people had already begun to clamour for a full-fledged gold currency standard.

1925-31. The Defects of the Gold Exchange Standard. In 1925 the Indian currency came under the searching examination of the Hilton-Young Commission. The Commission pointed out the following defects in the pre-War Gold Exchange Standard of India:—

1. The Government had the monopoly of metallic and paper currency whose value in respect of the international currency (gold) was maintained through the complicated device of Council and Reverse Council Bills. The system was, therefore, far from simple and its complete mechanism was not easily intelligible to a lay man in the street.

2. It did not secure automatic expansion and contraction of currency. The Government had great incentive to inflate currency but there was no machinery with which to pump

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1 These bills were met by selling sterling securities and treasury bills belonging to the Paper Currency Reserve. These securities had been bought at Rs. 15 to the £ but sold at Rs. 7 to 10 to the £ and there was thus a loss of about Rs. 35 crores.

2 *Report of the Controller of Currency* for 1920-21.

out superfluous currency except that of Reverse Council Bills[1] which were only sold on those rare occasions when the balance of trade was unfavourable to India.

3. It did not provide natural correctives to exchange such as are possible in the case of a complete gold standard when gold can go in and out of the country and thereby affect price-levels.
4. Its stability was always threatened by a rise in the price of silver because the standard token coin, *viz.*, the rupee, was liable to disappear if the price of silver rose above the melting point (as during the War).
5. There was a cumbrous duplication of reserves (currency and banking reserves) with a dangerous division of responsibility for the control of the currency policy which, in other countries, is vested in a Central Bank.
6. Since it could be easily managed and artificially manipulated by the Government it failed to inspire public confidence.

The supporters of the old system, however, maintained that the Gold Exchange Standard was not introduced by any body as such but that it was the result of a gradual process of evolution. Far from being artificially retained by the Government for their own advantage it was admirably suited to the peculiar needs of poor India[2] especially because it economised the use of precious metals and enabled a fairly stable rate of exchange to be maintained with countries on the gold standard.

These arguments are not very convincing. As against the argument that the gold exchange standard is very much more economical than the gold standard in avoiding the costly locking-up of gold or the wasteful use of gold in circulation, it may be pointed out that the result of the working of the system has been just the reverse of what its advocates claim for it. "From the point of view of this country, the savings on the coinage of rupees under the Gold Exchange Standard, which now amounts to £40,000,000, are not available either for the development of our credit institutions or for the development of our nation-building departments as these savings are located and invested in London. The Gold Standard Reserve Fund also cannot be used for the purchase of industrial equipment in the world market as it is solely intended to maintain the stability of foreign exchange ....Far from economising the use of gold and giving the country the benefit of cheaper medium of exchange the Gold Exchange Standard has, in actual working, resulted in the most *foolish, extravagant and wasteful dissipation of the country's gold resources,* both inter-

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1 Even when Reverse Council Bills were sold, the Government failed to effect corresponding contraction of currency because the money was never locked out of circulation. See the *Report of the Hilton-Young Commission,* paras 16-17.

2 For other arguments in favaur of gold exchange standard revise Chapter IX.

nally and externally."[1] Referring to the difficulty of maintaining gold exchange standard, Dr. Canan wrote : "The percentage of administrators and legislators who understood the gold standard is painfully small but it is likely to remain ten or twenty times as great as the percentage that understands the Gold Exchange System. The possibility of a Gold Exchange System being *perverted to suit some corrupt purpose* is very considerably greater than the possibility of the simple gold standard being so perverted."[2]

It must also be remembered in this connection that the supreme consideration with the Government has all along been to prevent a *rise* in the *sterling value* of the rupee rather than the stability of the rupee *in terms of prices in India.* Chablani is, therefore, right when he says that the "Indian currency system was a *dependent* standard and a clumsy one at that."[3]

The Sterling Exchange Standard Rejected. Having rejected the Gold Exchange Standard the Commission considered the advisability of recommending the sterling exchange standard. This system could be established by requiring the currency authority to sell rupees for sterling without limit at the upper specie point of a fixed parity and to sell sterling for rupees at the lower gold point of the same parity. It would have been *cheap* and *automatic* in its working but the Commission rejected it on the ground that it contained all the defects of the gold exchange standard and left Indian currency, exchange and prices to the mercy of the English currency system. That their fears were not ill-founded has been amply borne out by what happened after September 1931 when sterling was divorced from gold and the Indian currency suffered in common with the depreciated sterling.

Commission's Objections Against Gold Currency Standard. The Commission were also opposed to the introduction of gold currency standard[4] on the ground that it was difficult, if not impossible, to obtain the required supplies of gold. The American and English evidence left no doubt about this point. "Both authorities view the proposal with alarm on the grounds that it would retard the progress of monetary reconstruction in Europe, would upset world prices and would be fundamentally harmful to India and to the rest of the world."[5] They also feared that an increase in the demand for the yellow metal would raise *its* price and thus *accentuate the downward trend of prices* all over the world. They showed great concern for China and the Indian agriculturists who had put their savings in

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1 Wadia and Joshi—*op, cit,.* pp. 269-271.

2 See his Foreword to *The Problem of the Rupee* by B. R. Ambedkar.

3 *Studies in Indian Currency and Exchange,* p. 92.

4 Which was proposed by the Government of India (Blackett Scheme) and supported by several eminent economists. This scheme in particular was rejected on account of the unreliability of its estimates.

5 *Hilton-Young Commission Report,* para 51.

silver and stood to lose heavily by its demonetisation. The Government were also expected to lose as their reserves were sure to depreciate in value. Moreover, at a time when the rest of the world was centralising its gold resources in the hands of central banks, it seemed to be preposterous why the people should clamour for the presence of gold coins in circulation although the stability of currency could be achieved without them.

The Gold Bullion Standard. Arguing that it was possible to have a true gold standard even without putting gold coins in circulation, the Commission recommended the adoption of the Gold Bullion Standard on the lines followed in England in 1925. They proposed "that the ordinary medium of circulation in India should remain, as at present, the currency note and the silver rupee and that the stability of the currency in terms of gold should be secured by making the currency directly convertible into gold for all purposes but that gold should not circulate as money." Under the Commission's scheme, rupees and notes were to legally cease to be convertible into each other and a legal obligation was to be imposed upon the Central Bank suggested by them to buy and sell gold (at rates determined with reference to the gold value of the rupee, *viz.*, 1s. 6d.) in amounts of not less than 400 ounces—no restriction being imposed as to the purpose for which the gold was to be required. Gold was thus to be made the *real* standard of value which, unlike the pre-War gold exchange standard, would be entirely *independent* of the sterling and other groups of currencies. It was further claimed that the scheme represented an absolute gold standard as under it the gold bars were to be given not for export but for *any* purpose. Some critics maintained that under the Gold Bullion Standard token currency will be convertible into gold only for export and not for all purposes.[1] They also pointed out that under the Gold Exchange Standard notes were at least convertible into a better currency, namely, rupees but under the Gold Bullion Standard they were, to all intents and purposes, inconvertible. They, however, forgot that the *very fact of convertibility* would be an effective check on the Central Bank's power of inflation and remove the very cause that induces most people to present their notes for conversion into better currency *viz.*, the depreciation of token coins. Moreover, it would remove the long-standing anomaly of one token coin being convertible into another token coin. The convertibility of the rupee and the paper currency into actual gold being guaranteed, it was believed that the confidence of the public would be enlisted and the temptation to hoarding would be successfully checked. In order further to convince the public of the solidity of the gold basis of the rupee the Central Bank was to issue Gold Bullion Certificates of one tola or less redeemable in 3 or 5 years in legal tender currency or gold at the option of the holder. The holder was to be given facilities to get them encashed at any time during their currency at certain

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1 Brij Narain—*Indian Economic Life*, p. 242.

rates of discount but until the date of maturity they would be paid in legal tender money and not in gold.

It was, therefore, expected that the Gold Bullion Standard would be more *simple, certain* and *automatic* in its working than the gold exchange standard, that it would *promote habits of banking and investment* and that it would be *free* from the threat implied in the rise in the price of silver.

The Ratio Problem. It has already been pointed out that the attempt to give a high external value (2s. gold) to the rupee in 1919 ended in smoke in 1922. The adverse balance of trade and high prices continued for more than a year and the exchange further declined to below 1 shilling. In 1922-23, however, the balance of trade improved in favour of India with the result that the exchange touched 1s. 4d. in September 1924, rose to 1s. 6d. in May and remained firm at 1s. 6·5/32d. for the next two years. The Indian prices fell from 176 in 1922, to 159 in 1925 and incidentally coincided with the level of world gold prices which was also about 159. In 1926 prices fell to 148 both in India and in the United Kingdom.

Arguments for 1s. 6d. Arguing that during the period of change there was a mutual adjustment of prices and exchange, the Hilton-Young Commission recommended that the rupee should be established in relation to gold at the rate of 1s. 6d. for the rupee.[1] They also suggested that the wages of industrial and agricultural labourers had been adjusted to the new level of prices and that it was not desirable to produce a concealed reduction in wages by adopting a lower ratio (implying a higher level of prices). The Commission contended that reversion to 1s. 4d. would bring about a rise of prices by 12½ per cent. which would dislocate commerce and trade and substantially reduce the purchasing power of the people earning fixed incomes. They admitted that the burden of land revenue in terms of purchasing power had increased because many of the current settlements were made when exchange was at 1s. 4d. but they were of the opinion that the loss of the agriculturists had been more than made up by the high level of prices during and after the War. Other contracts were either short-period contracts, that is, they were entered into when the exchange was at (or near) 1s. 6d. or they were concluded at a time when exchange was unstable and it was impossible to do absolute justice to the creditors and debtors by fixing on any particular rate of exchange.

Arguments for 1s. 4d. Sir Purshottamdas Thakurdas, a member of the Commission, in his elaborate Minute of Dissent, challenged these statements and stressed the desirability of stabilising exchange at 1s. 4d. He held that the adjustment between the Indian and world prices was not complete and that the ratio of 1s. 6d. was artificially worked up by deliberately contracting currency. He also pointed out that, until adjustment was complete

1 Thus making the rupee equal to 8·47 grains of fine gold.

1s. 6d. ratio conferred an indirect bounty of 12½ per cent on the foreign manufacturer at the cost of the Indian producer and aggravated the distress of the debtors, including the agriculturists, who had to give more purchasing power in settlement of debts owing to them. He admitted that 1s. 4d. would increase the burden of the Home Charges but thought that the loss of Government would be more than made up by increased revenue from custom duties and income tax which was inevitable if industries were adequately protected against foreign competition. As to labour, the then existing rate of wages was sufficiently high to cover a possible rise of prices caused by the adoption of 1s. 4d. In any case, there was compensating advantage of continuity of employment due to the fact that the lower ratio would ensure greater prosperity to industry and agriculture while the higher ratio was sure to injure both. He also blamed the Government for throwing away an opportunity of restoring the exchange to the pre-War ratio of 1s. 4d. in September, 1924 when the exchange had actually touched 1s. 6d. Other arguments urged in favour of 1s. 4d. were that it was a natural and a *de facto* rate and that while at 1s. 4d. the sovereign is equal to Rs. 15, at 1s. 6d. it is equal to Rs. 13-5-4 which is difficult to remember.

The Ratio Controversy Examined. It is rather interesting to note that the exponents of the new ratio have made use of the same statistics to support their case as the opponents have used to demolish it showing clearly that index numbers are by no means an infallible guide for the study of such intricate problems.[1]

The whole discussion virtually centred round *adjustments*—the adjustment of Indian prices to world prices and the adjustment of wages and contracts etc., in India to the then existing level of Indian prices. It can scarcely be denied that the adjustment was not complete but it should also be admitted that under the conditions then prevailing it was easier to adopt 1s. 6d. than 1s. 4d. The Commission failed to adduce sufficient statistical evidence to prove that the long period contracts were not likely to be affected by the high ratio or that agricultural wages were in adjustment. In fact they gave away their case by attempting to minimise the losses of agriculturists by saying that they had already been compensated by heavy profits made by them since 1914.

The supporters of 16d. ratio, similarly, could not establish the fact of any substantial contraction of currency. They also failed to recognise that the loss sustained by the manufacturers and the agriculturists was small and transitory because it was likely to be offset by a corresponding (and even greater) fall in the price of implements, raw materials and other articles of daily consumption. The claim that 1s. 4d. was a natural and a *de facto* rate was obviously untenable because, so long as the rupee is a token coin, the question of a natural

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1 *See the Report of the Hilton Young Commission,* paras. 178-79.

rate cannot arise. Any rate, provided it can be successfully maintained over a fairly long period of time, has the same right to be called 'natural' as 1s. 4d. The argument that at 1s. 6d. the rupee would be equal to Rs. 13-5-4 is also fantastic. Besides, it loses sight of the fact that under the recommendations of the Hilton Young Commission the sovereign ceases to be legal tender.

Conclusion. Considering that 1s. 6d. had been maintained for over five years (1922-26) and that a sudden lowering of the ratio would have involved excessive economic disturbance, the Commission were thoroughly justified in recommending its stabilisation at that rate. Nevertheless, there is no gainsaying the fact that 1s. 4d. is calculated to promote the interest of a larger section of the community more than any higher rate. It also assimilates the Indian currency system to that of England much more easily than any other rate at which the gold mohur formerly exchanged for rupees. The rupee contains 16 subsidiary units called annas, therefore one anna would become equivalent to one penny. The anna is equivalent to 4 pice which would give to the pice and the farthing the same value and finally, the Indian pice is equivalent to three pies, making the pie equal to one-third of a farthing. "When one considers the close fiscal and commercial ties existing between India and the mother country and the prospect at the time that the sovereign would soon become an important coin in India's monetary system, this close assimilation of sovereign and the rupee units and their fractions will be seen to be a meritorious feature of the 16d. rate."[1] The Government should, therefore, strive to reinstate it as and when a suitable opportunity offers itself.[2]

The Act of 1927.[3] The scheme sanctioning the establishment of a Central Bank, which was to be a necessary counter-part of the Gold Bullion Standard, was turned down by the Legislative Assembly in 1927 although the Gold Bullion Standard itself was approved. Act No. IV of 1927 fixed the gold value of rupees and notes at 8·47512 grains for one rupee and imposed a legal obligation on the Government to buy gold at a price of Rs. 21-3-4 per tola of fine gold in the form of bars containing not less than 40 tolas and to sell, for legal tender currency, gold for delivery at Bombay Mint, *or at the option of the Government sterling* in London in amounts of not less than 400 ounces (1065 tolas). A rate of 1s. 5·49/64d. was notified as Government's selling rate for sterling to meet these obligations. This virtually committed the Government of India to the Gold Bullion Standard at the rate of 1s. 6d. per rupee although it was strictly speaking a

1 Kemmerer-*Modern Currency Reforms*.

2 One such opportunity presented itself in September 1931 when England abandoned the gold standard and the Government were free to change ratio in terms of sterling.

3 For an excellent summary of the Act read L. C. Jain—*The Monetary Problems of India,* pp. 33-35.

Sterling Exchange Standard.[1]

Failure of the Gold Bullion Standard—The Sterling Exchange Standard. The new standard was better than the pre-war gold exchange standard in as much as there was a statutory gold parity for the rupee and a statutory obligation on government with regard to the purchase and sale of gold. But it still retained most of the old characteristics which had so strongly been condemned by the Hilton Young Commission *viz.*, the conversion of one token currency (silver rupee) into another (paper note), the duplication of reserves and the separation of currency from credit control.

The attempt to link the rupee to sterling in the guise of the Gold Bullion Standard proved a dismal failure and Government threw overbroad all pretensions of putting the rupee on gold parity in 1931. In the beginning of that fateful year many European countries withdrew their deposits from London. Faced with a serious budget deficit on one side and the speedy exhaustion of its gold resources on the other the British Government authorised the Bank of England to suspend the operation of the Gold Standard Act of 1925. The gold standard was thus suspended in England. This decision was arrived at late in the evening of the 21st September 1931 and the following morning the Viceroy on the advice of the Finance Member issued Ordinance No. VI of 1931 temporarily relieving the Government of India of their obligations to sell gold or sterling. To the great surprise of every body in this country, within a few hours of this decision being taken by the Government, Sir Samuel Hoare informed a subcommittee of the Round Table Conference that the rupee would continue to be maintained at 18d. sterling. Evidently there was a very wide difference of opinion between the Government of India and the Secretary of State. In order, therefore, to acquaint the Secretary of State of their views in the matter and to prevent all panicky developments, the Government of India declared a compulsory bank holiday. On the resumption of work on the 25th September the Government promulgated another Ordinance repealing that of the 21st and authorising the Government to sell gold or sterling for genuine trade requirements only and for reasonable personal or domestic

1 Because by reserving to themselves the right of converting token currency into gold or sterling the government *really* aimed at the sterling exchange standard.

"But it is fair to point out," says Dr. L. C. Jain, "that so long as sterling did not go off the gold parity, the sterling exchange was as good or as bad as the gold exchange standard. Further, if government chose to exercise the further option open to it of offering gold in exchange for rupees, Indians would have had, in point of fact, if not in law, a gold standard. Thus the standard of 1927, though a sterling exchange standard, was capable of becoming a gold standard and certainly indicated that the gold standard was the ideal of Government."—*The Indian Monetary Problems*, pp. 35.

The real intentions of the Government became apparent in September 1931 when instead of converting rupees into gold they offered to convert them into sterling.

purposes.[1]

The action of the Government in linking the rupee to sterling instead of gold was greatly resented by the Indian people. The criticism was not merely sentimental but was based on several serious considerations. In the first place, it made the prices in India dependent upon British prices which were not likely to be very stable after the abandonment of the gold standard. Secondly, it placed India's import trade with gold standard countries at a disadvantage as compared to her trade with countries which were divorced from gold. It only helped England to sell her products into India at a greater advantage over her European rivals.[2] Thirdly, it necessitated the sale of Reverse Council Bills which exhausted the Indian reserves in England. But by far the worst consequence of linking the rupee to sterling was the export of gold.

The Export of Gold. The traffic in gold is a normal feature of international trade. Every country imports and exports every year but some import more than what they export and some export more than what they import. Owing to her favourable trade balance, the balance of trade in gold was generally in favour of India but during the last few years more than Rs. 300[3] crores worth of gold had been exported. Some of this had been sent out immediately after the economic depression in 1928 from the Punjab and United Provinces which were more severely affected by the crisis and was called *distress gold* but the major portion had been exported after September 1931. The price of gold rose by about Rs. 10 per tola and people parted with it merely out of consideration of making profit.[4] Ever since the flight of gold began, the people of India urged upon the Government the immediate necessity of stopping it but nothing of the kind

1 The Gold and Sterling Regulation Ordinance of 1931 was cancelled in January 1932 which meant that the Currency Act of 1927 again came into operation. But so long as sterling remains cut off from gold the Indian monetary standard remains a sterling exchange standard. The cancellation has simply taken away the restrictions on exchange transactions but it has in no way changed the essential characteristic of the Indian system as being linked to sterling which is divorced from gold.

2 "With a rupee equal to 1s. 6d. sterling, which bought less American or French gold currency than before, it became less profitable for an Indian importer to import goods from America or France which were still on the gold standard than, for instance, from England which had departed from it." Jain—*op. cit.* p. 45.

3 The exact amount was Rs. 314·6 crores for the last 7 years—1931-38.

4 It should be remembered that a rise in the price of gold *alone* was not enough to enable people to export their gold to other countries. If a rise in the rupee price of gold in India had been exactly offset by a depreciation of the rupee, there could not have been any gain from such export. Gold was exported because a rise in the price of gold in India brought forth a large supply of *distress gold* in the market which did not allow the price of gold in India to rise to the same extent as it would have risen in the absence of distress gold. In other words, though the price of gold had risen in India as well as outside, the *extent of the rise* was smaller in India than in other countries with depreciated currencies. Hence the depreciation of the rupee in terms of gold being smaller than its depreciation in terms of any stable currency like dollar, it was clearly profitable to export gold.

was done because the Government expected many advantages from the export of gold. Their case may be summed up thus :—

(1) There was nothing abnormal about the present export of gold because it was a normal feature of the trade of the country.
(2) Gold exports had led to an improvement in the credit of the Government. This enabled the Government to stabilise exchange by purchasing sterling at favourable prices. It also enabled the Government to pay off the 15 millions sterling debt and to reduce their floating debt in India by creating fresh currency to pay for the gold.
(3) Gold exports had strengthened India's public reserves. Although there was practically no increase in the quantity of gold in the reserve, its value at the market rate increased by about 5 crores of rupees.
(4) Gold exports had enabled persons, especially the agriculturists, to live upon their past savings and to make a huge profit into the bargain.
(5) Gold exports had encouraged flow of international trade. They had not only helped India to buy more foreign goods but had increased the purchasing power of her potential customers.

Some of these arguments appeared to be frivolous. India may have exported gold in the past but it was open secret that she always imported more gold than what she exported during the last ten years except, perhaps, 1921-22 as the following table will show :—

(value in crores of rupees)

	Import	Export	Net Import+ ,, Export—
Average for 1910—11 to 1914—15	29·92	4·57	+25·35
Average for 1915—16 to 1919—20	19·64	6·23	+13·41
Average for 1920—21 to 1924—25	36·45	7·74	+28·71
1925—26	35·22	·37	+34·85
1926—27	19·50	·10	+19·40
1927—28	18·13	·03	+18·10
1928—29	21·21	·02	+21·19
1929—30	14·23	·01	+14·22
1930—31	13·24	·49	+12·75
1931—32	2·79	60·77	—57·98
1932—33	1·31	66·84	—65·53
1933—34	1·09	58·15	—57·06
1934—35	·71	53·25	—52·54
1935—36	·94	38·30	—37·36
1936—37	1·60	29·45	—27·85
1937—38	1·56	17·90	—16·34
Total for 21 years from 1910—11 to 1930—31	551·67	93·81	+457·86
Total for 7 years from 1931—32 to 1937—38	10·06	32·68	—314·62

Moreover, if the gold exported at that time was distress gold, it was not clear why it should be sold by the people who have not been affected by the economic crisis or why it should not be sold within the country itself. It may also be mentioned that, inspite of heavy gold exports, the exports of Indian merchandise had not shown appreciable tendency to increase. On the other hand, they had concealed an unsatisfactory state of affairs namely the alarming fall in the export of merchandise. Dr. L. C. Jain rightly pointed out,[1] "Gold exports are at best only postponing the evil. When they cease, and it should not be very long before they cease, a situation of the gravest character will arise if things are allowed to drift in the mere expectation of international action leading to world prosperity." The only reason, therefore, why the Government did not stop the flight of gold seemed to be that "Gold exports have enabled the United Kingdom to pay part of her debts to France and United States."[2] It was also true to say that if the people had not sold their capital resources they would have been unable to pay the Government dues which were very inelastic.

In fairness to the Government, however, it must be admitted that the dangers of gold exports were greatly exaggerated by giving the whole problem a political colour. In so far as hoarded gold had been sold there had occurred an immediate economic benefit to the holders of gold and certainly the amount that had gone out was only a part of the total amount available in India. It is true that the Government could have stopped the heavy outflow of gold (1) by putting an embargo on gold export, and/or (2) by purchasing gold at the market price. The first procedure could have benefitted none and only injured the genuine sellers, especially the victims of the trade depression. The second alternative would have launched the Government into a speculative business in a commodity whose price was fluctuating. We could only pin our faith in India's lust for gold which had earned her great notoriety. As soon as trade conditions became more favourable, it was hoped, the lost gold would flow back to us in increasing amount.

In 1938-39, India exported gold for Rs. 13·79 crores and the gold earmarked with the Reserve Bank on account of purchasers abroad was Rs. 10·19 crores. The exports in 1939-40[3] were, curiously enough, on a vaster scale and the Reserve Bank's purchases of the metal for foreign constituents, though smaller, continued to persist. Between April 1939 and January 1940, India parted with valuable yellow metal for 42·02[4] crores and received in its place nothing but paper money in sterling and this was done during a period when India's favourable balance of trade in merchandise was Rs. 78·03

1 *Monetary Problems of India*, p. 51.

2 Brij Narayan—*India in the Crisis*, p. 107.

3 During the ten months, April 1939—January 1940, gold worth Rs. 33·94 crores was exported and the Reserve Bank bought gold in India and earmarked for overseas' clients to the extent of Rs. 9·08 crores.

4 It was Rs. 9·48 crores in 1939-40.

crores and when, ordinarily speaking, India should have got gold from foreign countries.

This loss of gold of Rs. 42·02 crores in favour of foreign countries could not be justified in a period of war and in conditions in which its place was being taken by more paper sterling. It is, therefore, suggested by many that the Government should adopt four definite lines of policy. *First*, export of gold must be banned. *Second*, no more gold should be brought in India on account of foreign constituents of the Reserve Bank. *Third*, the dollar balances accruing from our favourable merchandise balance of trade with the U. S. A. must be utilised for the purchase of gold in America. *Fourth*, the Reserve Bank must be enabled by a change in the statute to value its gold at current market rates and the Bank must be asked to buy gold for its reserve both in India and in America.

The System Before World War II. The country was on the sterling exchange standard. The Government had given an artificial value to the rupee in terms of sterling at Re. 1=18d. and maintained that parity between the specie points through the sale of sterling. The rupee was a token coin yet it was the principal medium of exchange and standard of value. Hence, it was still a standard token coin. Internally it was convertible into paper notes and other subsidiary currency and externally into sterling neither of which was convertible into gold. It performed all the functions of a currency note and differed from it only in that while the note was printed on paper, the rupee was printed on silver. It, therefore, continued to function as "an inconvertible note printed on silver."

Besides the rupee, other coins made of copper and silver were legal tender in India. These were one-anna, two-anna and four anna pieces in nickel, and pies in copper. Rupees and half rupees were full legal tender while other coins were legal tender upto one rupee.

It will be observed that the position of the rupee was even worse than it was before World War I. Upto 1915 the rupee was, at least in theory, convertible into gold for exchange purposes but now its value depended on that of sterling which was no longer linked to gold. "It is neither fish nor fowl nor bright red herring. For sheer inexplicability, manipulative facility, and complicated mechanism nothing approaching it has ever been invented."[1]

Apart from this, the monetary system was lacking in the degree of elasticity which provides for automatic expansion or contraction in accordance with the varying needs of trade and of a growing economy. Rupees, once put into circulation, did not return automatically when there was no need for them. They used to be an excellent means of in the shape of silver ornaments which could be liquidated only in times of severe distress when circulation would need to be

1 N. R. Sarkar in a speech delivered before the Currency League of India on the 25th October, 1933 at Bombay.

contracted, not expanded. If, on the other hand, more rupees were needed for circulation, they could only come from new minting of silver which would have to be imported from abroad. This would needlessly affect our trade balance. Moreover, there was no co-ordination between the total value of money of all kinds in circulation and the aggregate national economy. There was very little of the so-called "deposit currency" which every modern commercial country tends to develop more and more. Statistics of the Clearing House suggested relatively small proportion of the domestic trade of the country being settled by means of cheques or bills and there was no correlation between the total volume of money in circulation and the economic needs of the country, its productive capacity or distribution requirements.

The Fate of 18d. Ratio. The agitation in favour of 16d. ratio apparently died with the vote of the Assembly in 1927 but was soon revived by the quick march of events all over the world. The Working Committee of the Indian National Congress passed a resolution on 14th December, 1938 demanding the reduction of the ratio to 1s. 4d. The prices fell slowly upto 1929 and rather abruptly thereafter as the following figures will show :—

Year	India (Calcutta)	United Kingdom	United States of America	Japan
Average of				
1925	159	159	104	202
1926	148	148	100	179
1927	148	141	95	170
1928	145	140	97	171
1929	141	100	100	106
1930	116	88	91	82
1931	96	77	77	70
1932	91	75	68	73
1933	87	75	69	82
1934	89	77	79	81
1935	91	78	48	84
1936	92	83	85	90
1937	102	95	91	108
1938	98	93	84	113

This catastrophe was brought about by a variety of causes. Progress of mechanical inventions and of science in breeding new kinds of grains, seeds, cotton etc., unaccompanied by corresponding increase in consumption caused over-production. Post-war tariffs, quotas, financial restrictions, reparation payments etc., created a general feeling of insecurity and panic. Most of the gold was concentrated in the hands of France and U.S.A. leading to serious curtailment of currency and fall of prices in other countries. But whatever

the cause of this economic depression may have been, one thing was quite certain *viz.*, that it cut the purchasing power of the producers by half. Since the prices of agricultural produce fell more steeply than the prices of manufactured articles the agriculturists were obviously the worst sufferers much more so because interest charges and land revenue were inelastic. Many countries of the world sought to render necessary assistance to their producers by raising prices artificially. The following table gives an idea of the extent to which currencies of certain countries had depreciated after the war.

Country	Pre-War Parity £1=	Parity on Nov. 1 1933 £1=	Present value of foreign currency expressed as a percentage of its pre-War value
Belgium	25·207 Francs	111·40 Francs =22·48 Belgas	22·6 per cent
France	25·207 Francs	80 Francs	31·5 ,, ,,
Greece	25·207 Drachmae	555 Drachmae	4·5 ,, ,,
Italy	25·207 Lira	60 Lira	42·0 ,, ,,
Portugal	4·48 Esendos	103 Esendos	4·5 ,, ,,
Spain	15·207 Pesetas	37 Pesetas	68·0 ,, ,,

The relative depreciation of each of the above currencies is obvious but even the above table does not tell the full tale of the decline and fall of some of the more important countries with whom India comes in intimate contact. One such country was Japan. The Japanese Yen was then worth 50 per cent of what it was before the War. The pre-War parity of Yen 1=2s. 0·1/16d.[1] In 1932 the Yen 1=1s. 2·1/2d. The case of India was quite different. Forgetting the hectic days after the war when the rupee went upto 2s. 10d. and the people and the Government sustained heavy losses, the broad fact remained that the rupee which was equal to 1s. 4d. before the war was now equal to 1s. 6d. The £ which brought Rs. 15 before the war now brought only Rs. 13-5-4 or, in other words, the rupee was 112·5 per cent of its pre-War value in terms of the £. If, therefore, the history of world currencies was any guide, there did not seem to be much justification for hanging on to 1s. 6d. in India which was perhaps the only country to face the depression with an appreciated currency. Lord Linlithgow, as chairman of the Royal Agricultural Commission, had said "Raise the purchasing power of the *ryot* and help him to raise himself out of his present terribly depressed condition and in one stroke you will give to industry, to manufacture and

1 The American dollar is only 90 percent of its pre-War value. The currencies of Australia and Newzealand have depreciated by about 25 per cent and the currencies of Brazil, Argentine, Roumania etc., have depreciated beyond measure.

to commerce an extended field for service and so for legitimate gain." Unless His Excellency had since changed his mind he had to put his weight on the side of 16d. ratio.

Another interesting point borne out by a comparative study of index numbers is that, except in the two years (1924-26) to which the Hilton Young Commission referred as the basis of their recommendations in favour of the 18d. ratio, the Indian and British index numbers had never moved together. In fact the adjustment between the two price-levels was conspicuous by its absence. From 1929, the year of the commencement of the depression, Indian prices had been lowered by 43 points whereas British prices had suffered a fall of only 7 points. Moreover, while between September 1931 and March 1938 wholesale prices in England rose by 16 points, they increased in India only by 2 points. This proved conclusively that this country had not realised any thing like the benefits that were expected to be reaped simply by linking the rupee with a depreciated sterling without lowering the ratio.

A careful study of trade statistics reveals that our trade balance had sunk very low. From Rs. 86·5 crores in 1928-29 it declined to Rs. 79 crores in 1929-30 to Rs. 62 crores in 1930-31 to Rs. 34·8 crores in 1931-32 and to the almost unprecedented low figure of Rs. 3·4 crores in 1932-33. It is true that both imports and exports had fallen in value but it cannot be denied that the influence of the existing ratio has been exercised in the direction of discouraging the export trade of the country in favour of the import trade. Taking the figures for 1925-26 as the base, the following are the index figures for the imports and exports of private merchandise :—

	1925-26	1926-27	1927-28	1928-29	1929-30	1930-31	1931-32	1932-33
Imports	100	102	111	112	107	73	56	60
Exports	100	80	85	88	63	60	42	35

Such a continued disparity between the movements of import and export trade indicated that the rate of exchange was acting definitely to the detriment of the producers of exportable commodities. It will further be observed that since 1930 while the Indian prices had undergone a precipitous fall Japanese prices had actually shown an upward tendency. The Indian figure was 18 points below the 1930 level while the Japanese prices had risen by 3 points during the same period. It means that the Indian producers were being forced to sell at less than the pre-War prices goods which were produced at higher than the pre-War cost and to compete with Japan which had the further advantage of a depreciated exchange.

It was also sometimes asserted that the lowering of the ratio would adversely affect the wage-earners, the salaried and professional classes and the public revenues. This was true to the extent that a scaling down of the ratio would have been accompanied by a com-

parative rise in prices but experience has shown that low prices were not necessarily in the interest of people earning fixed incomes or even of the Government. If the price-level was lowered not only the producing but also the wage-earning classes had to bear the evil consequences. If the producers were forced to market their goods at unremunerative prices they were compelled either to reduce wages or to give up business. In both cases the wage earners suffered in the end, at least as much as the producers. The position of the professional and salaried classes was not essentially different. The demand for their services fell off and as the public or private employees experienced a shrinkage in their revenues they had to resort to curtailment of staff and retrenchment of salaries. Even the Government of India were not in a very happy position. They may have made a little saving in the remittance of Home Charges but this gain had been more than offset by a substantial fall in revenue. A straitened peasantry, an unemployed and impoverished middle class and a losing industrial and mercantile community were certainly not the best tax-payers. It had only amounted to killing the goose that lays the golden egg.

To the charge that the devaluation of the rupee would disturb the relation between creditors and debtors it may be replied that the creditors were hardly receiving anything and if prices were raised they at least stood a chance of melting the frozen credits and getting some return for their money which they would have cheerfully accepted.

The plight to which the nation at large and particularly the agriculturists had been reduced during the depression period is too pitiable for words. There was an urgent need for raising prices if trade, industry and agriculture were to be saved from the parlous state and for widening the channel of our export trade and so to increase the volume of our trade balance from which alone we can possibly meet our foreign obligations. It was, therefore, suggested that the Government should take early steps to restore the rupee to 1s. 4d. parity.

But the Government of India, in a *communique* issued on December 16, 1938 made it quite clear that they had no intention of lowering the exchange value of the rupee. Their argument was that barring the hectic years of the depression, the position was on the whole more favourable to India. For instance, the balance of trade was becoming increasingly favourable and the gold and sterling assets of the Reserve Bank were much stronger than before. The prices of agricultural produce had already begun to move upwards and further rise of prices would only raise the cost of the farmers. Moreover, the lower ratio was certain to weaken the budgetary position of the Central and Provincial Governments. In short, it was expected to benefit only the rich industrialists and the speculators and was not in the larger interest of the country.

SUMMARY

The Babington Smith Committee, appointed in 1919, recommended that sovereigns should be made legal tender in India although no legal obligations should be imposed on the Government to convert token currency into gold. The exchange value of the rupee in terms of the sovereign was fixed at 2s. gold which was then equivalent to about 3s. sterling. The reasons for recommending a high rate of exchange were that the rupee would remain a token coin and the resulting low level of prices would benefit the people at large. Substantial saving in the remittance of Home Charges was also expected.

Fate of 2s. Rate. Unfortunately for the Government, however, gold then was selling at a very much higher price than the one suggested by the Commission and no gold was tendered at the treasuries. Similarly owing to unfavourable balance of trade and continued high level of prices, the exchange weakened considerably. The Government tried to ease the situation by selling Reverse Council Bills but they only tended to make confusion worse confounded. Money was withdrawn from Indian investments and exported to England to take advantage of the high rate of exchange. The 2s. rate, therefore, broke down and the businessmen who had ordered goods in England in the hope that the exchange would remain at 2s. suffered heavy losses because they were called upon to make payment when the exchange had fallen to below 1s. Between 1922-25, there was no legal standard although the Government successfully attempted to maintain the value of the rupee in terms of the sterling at 1s. 6d.

The Hilton Young Commission. In 1926 the Indian currency sytem came under the searching examination of the Hilton Young Commission. The Commission suggested that the gold exchange standard was defective because it was difficult to understand. It did not provide automatic expansion and contraction of currency, necessitated the maintenance of unnecessary reserve and was looked upon with suspicion by the people. Some people supported the gold exchange standard on the ground that it was economical and particularly suited to India. They forgot that a system which locks up huge quantities of gold and silver without being used for industrial purposes and which is not easily intelligible to a layman in the street cannot function satisfactorily for any length of time.

The Commission rejected the sterling exchange standard on the ground that, in addition to all the defects of the gold exchange standard, it suffers from the additional disadvantage of making the monetary standard of the country *dependent* on the currency and prices of another. They also disapproved of the idea of introducing a gold currency standard because it was "untimely, unsound and impracticable." Finally, they recommended the Gold Bullion Standard according to which the rupees and notes were to cease to be convertible into each other and to be ultimately redeemable into gold bars of 400 ounces at all times and for all purposes at fixed rates calculated on the basis of the rupee being equal to 18d. The management of the system was to be entrusted to the Reserve Bank also suggested by them. Some people opposed the Gold Bullion Standard on the ground that the freedom to convert token currency into gold was nominal because few people could afford to purchase 400 ounces all at once. They also pointed out that in view of the fact that the notes would cease to be convertible into rupees their position would become much worse than before the War. In all fairness to the Commission it must be confessed that the very fact of convertibility (no matter in what form it may be) acts as a safety valve against deliberate and unconscious inflation of currency. Again, paper notes redeemable in gold bars would inspire greater confidence than those convertible into silver rupees which are themselves inconvertible. The Gold Bullion Standard is also likely to economise the use of gold and encourage habits of banking and thrift. It is, therefore, not only superior to the gold exchange standard but quite as *effective* and *practical* as the gold currency standard.

The Ratio Problem. After 1923 the prices fell and the balance of trade became more favourable so much so that the rate of exchange touched 1s. 4d. in September 1924, rose to 1s. 6d. in May and remained firm at that for the next two years. The Hilton Young Commission, therefore, recommended that the rupee should be stabilised at 1s. 6d.

Arguments for 1s. 6d. Other argument advanced in favour of 1s. 6d. were :—

(*a*) Indian prices were adjusted to world prices at 1s. 6d. the price-level in either country being 158.

(*b*) Reversion to 1s. 4d. would mean a rise of price by 12½ per cent, and

(*c*) In view of the fact that wages of industrial and agricultural labourers had been adjusted to 1s. 6d. the lower ratio would bring about a concealed reduction in wages.

(*d*) Similarly, most of the contracts were entered into when the exchange was 1s. 6d. and any lowering of the ratio would result in heavy losses to the creditors.

(*e*) The burden of the agriculturists in respect of land revenue would increase but this loss had already been made up by the high prices of agricultural products since the war.

Arguments for 1s. 4d.

(*a*) The adjustment between Indian and world prices was not complete.

(*b*) 1s. 4d. was a natural and a *de facto* rate while 1s. 6d. was brought about artificially by contracting currency.

(*c*) 1s. 6d. by lowering prices, pressed heavily on the manufacturer and conferred an unfair advantage on the foreign producers.

(*d*) The agriculturists stood to lose heavily for, while the prices of their products declined, their burden in respect of land revenue increased enormously.

(*e*) 1s. 4d. may be harmful to the wage earners but even their loss may be minimised by the continuity of employment which may be difficult if the manufacturers sustained heavy losses following the adoption of a higher ratio.

Conclusion. Much could be said on either side. In view of the fact that *stable* prices are always preferable to rising or falling prices, 1s. 6d. rate seemed to be more justified than 1s. 4d. But, as the country, in the long run, is likely to benefit more by 1s. 4d. it is suggested that the Government should expand currency gradually so as to be able to stabilise exchange at 1s. 4d. at the earliest possible opportunity.

The Act of 1927. According to the Act of 1927, the Government were bound to purchase gold in amounts of not less than 1,065 tolas at rates based on the 18d. value of the rupee.

The Act was, however, suspended in September, 1931, when England abandoned the gold standard. The present currency system of India is called the Sterling Exchange Standard. For internal purposes the rupee, as before, is the standard of value while for external purposes the Government have undertaken to convert notes and rupees into British sterling at 1s. 4d. The rupee, therefore, continues to be a standard token coin and still resembles an inconvertible note in all respects except that while the former is printed on silver the latter is printed on paper.

The fate of 18d. ratio. On account of the recent slump in prices the producers, particularly the agriculturists, have suffered a good deal. Other countries have tried to alleviate the distress of their producers by giving them larger purchasing power. India should do the same by reverting to 1s. 4d. Since England abandoned the gold standard British and Indian prices have not moved together. No useful purpose will, therefore, be served by being tied to the apronstrings of sterling. 1s. 4d. will not only help the trade and commerce of the country but it would also give immense relief to people earning fixed incomes by providing employment. The Government are almost certain to gain more from enhanced revenues than they are likely to lose in Home Remittances. Hence a strong case has been made out for a depreciation in the value of the rupee at least to bring it to its pre-War relation with the Pound Sterling. The Congress Working Committee passed a resolution favouring it but, unfortunately, the Government could not see its way to accept it.

QUESTIONS

1. Why did the Babington Smith Committee recommend the 2s. rate ? What was the fate of that ratio ?

2. Discuss the strong and the weak points of the Gold Exchange Standard as it prevailed in India before the War.

[Delhi Inter., 1929 and 1930, Punjab B. A. 1928]

3. Distinguish between the Gold Exchange Standard and the Gold Bullion Standard proposed by the Hilton Young Commission. State your views on the latter as a scheme of currency arrangement for the country.

[Punjab B. A. 1928 and Delhi Inter. 1930]

4. Examine the case of 18d. exchange value of the rupee as against 16d. exchange value. [Delhi Inter. and B. A. 1931 ; Agra B. A. 1935]

5. (a) What is the effect of a rate of exchange on price-level. Give Indian examples.

(b) How do changes in the value of money affect different classes of people in a country ?

6. Explain as simply as you can the recent changes in the monetary standard of India. [Delhi Inter. 1933].

7. Account for the unusual export of gold from India at the present time. Has India benefited by it ?

8. Describe briefly the currency system that is in vogue in India at the present time and explain the measures that are taken by the Government of India to maintain stability in the value of Indian currency in terms of foreign currencies.

[Agra B. A. 1934 and Punjab B.A. 1934].

CHAPTER XIII

THE INDIAN CURRENCY SYSTEM *(Continued)*

SINCE SEPTEMBER 3, 1939.

Great Britain got involved in the present War on September 3, 1939, to defend the fundamental right of nations to a free and peaceful existence and to uphold the sanctity of international agreements. She had the moral support of all the civilised nations of the world but their lip sympathy alone could not help her to win the war nor could the resources of Great Britain alone annihilate an enemy who had been preparing for protracted hostilities for a long time. The war called for enormous sacrifices on the part of the countries constituting the British Empire and necessitated vital changes in their economic organisation. Let us see how it has affected the currency and prices in India.

Withdrawal of Bank Deposits. As during the first Great War, the first instinct of the people at the outbreak of hostilities was to sell their Government securities, encash Post Office Cash Certificates, and withdraw their deposits from the banks including postal Savings Banks as the following figures will show :—

(A) Post Office Cash Certificates.

[In lakhs of rupees]

Year	Receipts	Repayments	Net receipts	Amount outstanding
1937-38	13,97	18,16	... —4,19	... 60,21
1938-39	14,71	15,35	... — 64	... 59,57
1939-40	10,25	12,80	... —2,55	... 57,02
1940-41	4,89	14,93	... —10,04	... 46,98
1941-42	3,97	11,94	... —7,97	... 39,01
1942-43	3,76	8,20	... —4,44	... 34,57
1943-44	5,50	5,43	... — 7	... 34,64
(B) Post Office Defence Savings Certificates[1]				
1940-41	...2,41	12	... 2,29	... 2,29
1941-42	...2,81	75	... 2,06	... 4,35
1942-43	...2,02	81	... 1,21	... 5,56
1943-44	...2,43	1,02	... 1,41	... 6,97
(C) Post Office National Savings Certificates.				
1943-44	... 8,66	1 ...	8,65	... 8,65

1 Replaced by the Twelve-years' National Savings Certificates from 1st October, 1943.

(A) Post Office Savings Banks

[In lakhs of rupees]

Year	Deposits	Interest	With-drawals	Net increase in Deposits	Amount outstand-ing
1937-38	43,27	1,46	39,76	4,97	77,59
1938-39	44,61	1,42	41,65	4,38	81,984
1939-40	40,50	1,15	45,22	—3,56	78,38
1940-41	25,35	93	45,09	—18,81	59,57
1941-42	21,91	83	30,18	—7,44	52,13
1942-43	22,26	73	22,84	15	52,28
1943-44	35,22	93	24,19	11,96	64,24
(B) Post Office Defence Savings Banks Deposits					
1941-42	11	...	...	11	11
1942-43	29	...	...	29	40
1943-44	3,59	...	...	3,58	3,98

This tendency was widespread soon after the enactment of the Emergency Power (Defence) Bill by the Government of the United Kingdom because rumours were current that the Government of India contemplated drastic measures for the control and confiscation of private wealth and property. The Government made adequate provision in the budget to meet these withdrawals and emphatically contradicted the rumours which had gained currency. Public confidence was soon restored which was evident from the fact that the panicky withdrawals ceased and the people began to invest more and more money in the National Savings Certificates and put in large sums of money in the Post Office Defence Savings Banks. That the panic did not last long is also borne out by a close scrutiny of the position of the scheduled banks as disclosed in their weekly returns :

		Demand Liabilities (In lakhs of rupees)		Time Liabilities (In lakhs of rupees)	
		Amount	Increase or decrease	Amount	Increase or decrease
August 25,	1939	142,58	...	106,87	...
September 29,	,,	139,21	—3,37	102,11	—4,76
October 27,	,,	140,82	+1,61	99,76	—2,35
November 24,	,,	145,04	+4,22	101,81	+2,05
December 29,	,,	146,57	+1,53	104,76	+2,95
January 26,	1940	146,43	— 14	107,89	+3,13
February 23,	,,	145,10	—1,33	109,09	+1,20
March 29,	,,	150,38	+5,28	108,08	—1,01
April 26,	,,	147,66	—2,72	113,08	+5,00
May 31,	,,	145,43	—2,23	112,14	— 94

		Demand Liabilities (In lakhs of Rs.)		Time Liabilities (in lakhs of Rs.)	
		Amount	Increase or decrease	Amount	Increase or decrease
June 7,	1940	144,31	—1,12	111,46	— 68
July 19,	,,	151,37	+7,06	106,83	—4,63
August 16,	,,	157,35	+5,98	104,02	—2,81
September 13,	,,	163,57	+6,22	101,11	—2,91
October 18,	,,	170,50	+6,93	100,38	— 73
November 15,	,,	175,31	+4,81	100,34	— 4
December 20,	,,	175,46	+ 15	101,03	+ 69
January 10,	1941	177,80	+1,34	100,92	— 11
February 14,	,,	177,83	+ 3	104,10	+3,18
March 14,	,,	179,87	+2,04	105,21	+1,11
April 18,	,,	184,44	+4,57	105,09	— 12
May 16,	,,	185,71	+1,27	106,40	+ 31
			+42,13		—1,47

It will be noticed that there were withdrawals from banks but they were no more than what the sheer instinct of precaution (which is far removed from panic) would justify. Moreover, although the rush for withdrawals was great in the beginning the withdrawals during May, 1940, which was a critical month, were less than in the first month of the War. It is also clear that in spite of frequent withdrawals the current accounts of scheduled banks upto May, 1941, had risen by more than Rs. 42 crores although the total deposits had increased by Rs. 40·66 crores only. Subsequent figures are even more encouraging.

Year	Demand Liabilities (In lakhs of rupees)	Time Liabilities (In lakhs of rupees)
1941-42	211,35	107,61
1942-43	306,28	104,21
1943-44	456,63	142,78
1944-45	584,80	194,12
1945-46	654,53	259,52
1946-47	725,54	323,11
March 1948	668,55	318,08
	(80,43)	(20,55)[1]

They show (1) that the study and continuous increase in the demand and time liabilities has been maintained ; (2) that the demand liabilities have increased by over Rs. 600 crores and the time

1 Figures in brackets ralate to Pakistan.

liabilities by over Rs. 230 crores since September, 1939 and (3) that the net increase in demand liabilities (5 times) has been more than the net increase in time liabilities (3 times).

Rush for Conversion of Notes. Rationing of Rupees. There was also a great demand for the conversion of notes. Prior to June, 1940, this demand was sporadic and averaged less than a crore of rupees per week but with the collapse of France in that month the total value of notes presented for encashment suddenly rose to Rs. 4 crores a week. There was thus a great strain on the rupee resources of the Reserve Bank. The demand for rupees further increased on account of the Government's increased expenditure on armament and defence and also on account of the increased business activity stimulated by the War. The Reserve Bank at first met this demand in full in the hope that such action would allay the fears of "panic-mongers" and check hoarding of rupees but the result was disappointing. Forty-two crores of rupee coins were issued in the first ten months—Rs. 13 crores having been put into circulation in June alone—but still there was chronic shortage. When the Government realised that meeting the public demand for rupee coins without limit did not relieve the strain and prevent the absorption of rupee coins they were forced to resort to the system of rationing under which the issue of rupees by the Reserve Bank to single tenderers was limited to normal legitimate requirements and the acquisition of rupees in excess of personal or business requirements was made punishable under the Defence of India Act. It was pointed out that the introduction of rationing was necessitated not by the shortage of silver but only by the mechanical limitations of the mints which were unable to mint coins in sufficient quantities and at sufficient speed to cope with the abnormal demand.

Issue of One-rupee Notes. As a result of large withdrawals of rupee coins from circulation much inconvenience was felt by the general public owing to the scarcity of a suitable medium of exchange of smaller value than the Reserve Bank notes of the lowest denomination, namely, Rs. 5. The Government, therefore, decided to supplement the stock of rupee coins by one-rupee notes issued on the authority of the Government of India. An Ordinance (No. IV of 1940) was accordingly issued on June 24, 1940, authorising such issue and providing that such notes will for all purposes be the equivalent of rupee coin. They were legal tender to exactly the same extent as rupee coin and not being bank notes or currency notes could be issued by the Reserve Bank in exchange for their bank notes to satisfy the demand for rupee coin. As the new notes could not be manufactured and put into circulation immediately, the Government made use of one-rupee notes which had already been printed in 1935 to meet a contingency of another nature.[1] These 1935 notes were

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1 The circumstances which led to the preparation of one-rupee notes in 1935 were as follows :—

(Continued)

printed on paper bearing as a water-mark the head of His Late Majesty King George V and were 3⅝ inches by 2⅛ inches in size. They contained a representation of the rupee coin on both sides and bore the signature of Mr. J.W. Kelly who was Controller of Currency in 1935. The new notes were also being printed at the Government of India Security Printing Press, Nasik.[1]

New Eight-anna Pieces. In view of the increasing simultaneous demand for four-anna pieces and half-rupees the Government of India felt that it would be extremely wasteful to turn out large quantities of half-rupees containing eleven-twelfths of silver and one-twelfth of alloy. They, therefore, decided that the fineness of one-half silver and one-half alloy prescribed for four-anna pieces in the Act passed by the Central Legislature should be adopted for eight-anna pieces as well. Ordinance No. VI of 1940 was accordingly promulgated to amend the Indian Coinage Act for this purpose. New half-rupees of the reduced fineness were exactly similar in weight and appearance to the old half-rupees but the ring was somewhat sharper. Half-rupees of the old fineness were no longer to be minted but were to continue to be legal tender.

Queen Victoria Rupees Withdrawn from Circulation. The Government had under consideration, even before the War, the question of withdrawing Victoria rupees and half-rupees. They were unpopular owing to the large number of counterfeits in existence which were difficult to detect owing to the worn condition of the coins. In view of the unsuitability of the coins as a media of currency and in order to recover them from the useless hoards, the Government decided to call them back. An Ordinance was promulgated on October 11, 1940

(*Continued*)

After the last war the price of silver fell very low and touched the rock-bottom level of 13·25d. per oz. (about 5 annas per tola) in 1931. In 1934, the countries interested in silver entered into a Four-year Agreement under which the Indian Government promised to sell not more than 35 million ounces of silver per year while the Government of the U.S.A., Australia, Canada, Mexico and Peru promised to purchase an equivalent amount. The U.S.A. went a step further in 1935. They undertook to buy silver until the silver stocks constituted 25 per cent of their metallic reserves and until the price of silver touched 64d. per oz.,*i.e.*, about Rs. 1-8 per tola. The result of such a policy, if consistently followed, would have been dangerous for silver-using countries. The U.S.A. commenced operations immediately after the Act was passed and in April, 1935, the price of silver rose to 36·25d. per oz. making the bullion value dangerously near its face value. As a direct result of this rise in the price of silver, China had to give up the silver standard and the Indian Government, in order to forestall an emergency, printed a large quantity of one-rupee notes. The anticipated danger, however, did not materialise on account of the reversal of the silver purchase policy of the U.S.A. and the price of silver receded back to the low level of 20d. in 1936 and remained between 16d. and 19d. during 1935-39. The occasion for putting the new notes in circulation, therefore, did not arise.

1 It may be interesting to note in this connection that the wear and tear of a rupee-note is very much greater than that of a silver rupee. The average abrasion of a rupee is 1·5 per cent in fifty years whereas the average life of a rupee-note is only six months. This is the reason why the Inchcape Committee recommended the withdrawal of one-rupee notes from circulation.

amending the Indian Coinage Act and by a Notification issued under the Act as amended it was declared that Victoria rupees and half-rupees shall cease to be legal tender after March 31, 1941, but shall continue to be acceptable until September 30, 1941, at all Government Treasuries and Post Offices and thereafter until further notice only at the Offices of the Issue Department of the Reserve Bank at Bombay and Calcutta.

New Rupee Coins. By an Ordinance issued on December 22, 1940, the Government were authorised to issue silver rupees of the fineness of one-half of alloy, *i.e.*, containing 90 grains of pure silver and 90 grains of baser metals. These new rupees contained a "security edge device" which was considered to be a complete safeguard against counterfeiting. For over a century the people of India had been used to rupees weighing one tola and containing 165 grains of pure silver and the new issue containing a much smaller percentage of silver was being accepted by them not without considerable suspicion and misgivings. Moreover, there were, at that time, three different forms of one-rupee units in circulation—the old 22 carat silver rupees, the new 12 carat silver rupees and one-rupee notes. They circulated only so long as the demand for money was great but if confidence was somehow shaken the old rupees were bound to go back into the hoards.[1]

Scarcity of Small Change. In spite of the Government's effort to increase the amount of currency in circulation there was an acute shortage of small coins especially after 1942. This shortage was partly due to increased business activity and partly to the chronic habit of hoarding. By a Notification issued on April 17, 1943, the possession of small coins in excess of one's genuine personal or business requirements was made an offence. At the same time large quantities of small coins differing in weight and fineness from the old coins were poured out of the mints. A new half-anna nickel-brass coin was issued in January, 1942, and a new design of pice weighing only 30 grains instead of 75 grains, round in shape, and with a round hole in the middle was given out to the public in February, 1943. The new pice, however, soon became scarce owing to its profitable use as a washer.

The standard weight of the two-anna, one-anna, half-anna and quarter-anna pieces was fixed with effect from January, 1943, as 90, 60, 45 and 30 grains, respectively, and in the making of these coins a remedy not exceeding one-fortieth of the standard weight was allowed.

A New Mint for Calcutta. Owing to the increased demand for coinage caused by the War a heavy strain was put on the mints at Bombay and Calcutta and the extension of plant capacity became necessary. The Government accordingly decided to construct a new mint at Calcutta at a cost of about Rs. 65 lakhs. This mint had a normal capacity of Rs. 6 lakhs per day or approximately double the then existing output when the mint was working full overtime. It

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1 Due to the operation of Gresham's Law.

was proposed to close down the old mint when the situation returned to normal and to extend the new mint for the production of nickel, bronze and silver coins as well.

Increase in the Volume of Circulating Media. The total amount of currency of every kind had increased by about Rs. 882 crores during the five War years 1939-40 to 1943-44, as follows :—

	Notes	Rupees	Small coins	Total
1939-40	+ 49,45	+ 10,08	+ 2,21	+ 61,74
1940-41	+ 19,11	+ 33,23	+ 4,28	+ 56,62
1941-42	+152,40	+ 7,18	+ 5,06	+164,64
1942-43	+261,85	+ 44,93	+ 11,64	+318,42
1943-44	+238,91	+ 23,14	+ 18,46	+280,51
Total for 5 yrs.— 1939-40 to 1943-44	+721,72[1]	+118,56	+ 41,65	+881,93

A careful analysis of the balance-sheet of the Reserve Bank for the week ended May 11, 1945, will show that the position of India's currency was quite sound. The assets of the Bank in the Issue Department in gold coin, gold bullion and sterling securities had increased from 63 per cent in 1939 to 93·5 per cent in May, 1945. They were thus 53·5 per cent more than the conservative limit of 40 per cent fixed by the Reserve Bank of India Act. Every paper note was thus fully backed by assets realisable at a moment's notice.

Nevertheless, a careful analysis of the composition of the reserve will show that the law had been violated in spirit if not in form for the proportion of sterling securities had increased at the expense of silver and gold. While the amount of gold had remained fixed at Rs. 44·41 crores the amount of silver coin had decreased from Rs. 75·87 crores to Rs. 15·9 crores between 1939 and 1945. Considering that the liabilities of the Bank in respect of note-issue had increased considerably in the meanwhile the percentage of gold in the reserve had *declined* from 20·5 per cent to less than 4 per cent and the percentage of silver and silver securities from 42·5 to 6·5 per cent, the percentage of sterling securities had *increased* from 27 to 89·5 per cent. Had the sterling securities been at par with gold a little increase of the former or a small decrease in the latter would not have made any appreciable difference to the reserve. But this was not the case then. Apart from the loss arising out of the depreciation of sterling securities the country was faced with the problem of inflation which was due to the accumulation of these securities and the difficulty of their cancellation or conversion in Indian money. A glance at the table showing the absorption of notes and rupees will show that the panicky demand for coins was a thing of the past, that more or less

1 Including Government of India one-rupee notes since July, 1940.

complete confidence had been restored in this respect, that one-rupee notes were circulating freely not only in the cities and towns but also in the rural areas and that the coins were slowly but surely coming back from the hoards.

Balance of Trade. Restrictions on Imports and Exports. The War also changed the character and the direction of India's foreign trade. The imports of many commodities were reduced or eliminated either because the former suppliers of goods became enemies or because the friendly countries were engaged in the production of war materials only and were, therefore, unable to supply civilian goods. Shortage of transport facilities and the difficulty of foreign remittance also helped to reduce the volume of our imports from Rs. 152 crores in 1938-39 to Rs. 119 crores in 1943-44. Restrictions had to be imposed on exports not only to prevent supplies from reaching the enemy by indirect channels but also to conserve supplies of all essential articles whether for the requirements of India or for those of the Allied countries. But such was the great demand for Indian goods from the different theatres of war that the value of exports actually increased from Rs. 163 crores in 1938-39 to Rs. 199 crores in 1943-44 leaving a net balance of about Rs. 80 crores in her favour, as the following table will show :—

[In crores of rupees]

Year	Imports	Exports	Total	Balance
1938-39	152	163	315	11
1939-40	165	204	369	39
1940-41	157	187	344	30
1941-42	173	238	411	65
1942-43	110	188	298	78
1943-44	119	199	318	80

This favourable balance of trade led to the accumulation of huge sterling balances in England. Provided England did not adopt an unreasonable attitude towards repayment these credits should leave India free to trade with other countries and obviate the need of manipulating the rate of exchange. They should also solve the problem of Home Charges which had been a subject of much adverse comment before the War.

A glance at the table on next page will show that whereas the import of foodgrains decreased from 15·7 per cent in 1938-39 to 7·3 in 1942-43, their export increased from 23·3 to 25·1 per cent during the same period. This created an acute scarcity of foodstuffs which claimed a very heavy toll of life in Bengal and the Malabar Coast in 1942-43. The reduction in the import of manufactured goods such as cloth also caused great hardship except perhaps in those

cases where indigenous products had been substituted for goods of foreign make.

Percentage of Total Imports

	1938-39	1939-40	1940-41	1941-42	1942-43
Foodstuffs ...	15·7	21·4	15·2	16·1	7·3
Raw Materials ...	21·7	21·9	26·8	28·8	47·3
Manufactured goods	60·8	55·5	57·0	54·1	44·5
Percentage of Total Exports					
Foodstuffs ...	23·3	19·0	21·3	23·8	25·1
Raw Materials ...	45·1	42·9	34·4	28·9	23·1
Manufactured goods	30·0	37·0	43·1	45·5	50·3

The War also changed the relative importance of different markets. The percentage of exports going to the Empire countries increased while the imports from such countries increased less than imports from others. Among the non-Empire countries, China and the U. S. A. were our principal customers.

Exchange Control Restrictions. Following the example of Great Britain, the Government of India also undertook to control exchange. Part XIV of the Defence of India Ordinance 1939 contained financial provisions, providing *inter alia* for (*i*) restrictions on purchases of foreign exchange, (*ii*) acquisition by the Central Government of foreign exchange, (*iii*) restrictions on purchases and export of securities, and (*iv*) acquisition by the Central Government of foreign securities. All foreign exchange transactions were required to be put through authorised dealers controlled by the Reserve Bank. Restrictions were placed on the purchase and sale of Empire currencies while the sale and purchase of non-Empire currencies were restricted to genuine trade purposes, travelling expenses and small personal remittances. The export from India of any currency notes or coins, whether Indian or foreign, except under a licence from the Reserve Bank was prohibited. Taking out of gold in any form from India without permission of the Bank was also prohibited.

As a large amount of the essential war material had to be purchased from America, including motor transport for the mechanisation of the Indian Army, it was particularly necessary to conserve all dollar resources for Commonwealth needs. For this purpose dollar balances were taken over by the Reserve Bank, remittances to the

United States or Canada were banned, imports of luxury goods from outside the sterling area were restricted to the minimum, imports of silver were forbidden except under licence and dollar exchange was granted only to persons travelling abroad in the national interest.

The policy of the Reserve Bank of India had been to ensure that all transactions were put through on the basis of the rates fixed by the London Exchange Control. In the early stages of the control it was possible for the American importers of Indian goods to evade the regulations. The creation of a free sterling market in America, no doubt, resulted in some loss to the Indian exporters but with the tightening up of the Control the rates became more effiecint.[1]

Owing to the difficulty of obtaining cover in London for positions other than spot, forward exchange business on the part of banks was paralysed. The Reserve Bank, therefore, announced on October 3, 1939, that it would be prepared in future to purchase sterling for forward delivery extending over a period of 90 days at 1/32 per month higher than its spot buying rate. This innovation was unique in the currency history of India. In February 1940, the Reserve Bank decided to buy sterling at 1s. 6d. up to 6 months forward. On October 16, 1940, the Bank announced that the exporters of gold from India to the U.S.A. must surrender at least 34 dollars for each fine ounce of gold exported. It also announced its readiness to buy dollars for spot delivery. On March 9, 1940, the Bank also announced its scheme for the control of the foreign exchange proceeds of certain exports to 'the hard currency' countries, *i.e.*, countries having currencies based on gold (like the U. S. dollar and the Swiss franc) or linked to currencies which are based on gold. The commodities affected were jute, jute manufactures and rubber. The object of the scheme was to obtain control of the foreign currency proceeds of the exports and also to see that full export proceeds (based on the official rate of dollar-sterling exchange) of the goods were received.[2]

The balances of all Japanese companies and firms resident in India were frozen in 1941. These accounts were taken over by the Custodian of Enemy Property and could not be used except with the permission of the Reserve Bank. In 1942 the accounts of persons and firms resident in Japanese occupied territories such as Hong

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1 In order to understand the difference between "official" and "free" sterling the advanced student is advised to read "*Review of Trade in India*" for 1939-40 and 1940-41 and an excellent article—*India and the Two Sterlings*—in the July number of the Indian Institute of Bankers."

2 The combined effect of these measures adopted by the Government for the control of exchange has been to keep the exchange pegged at 1s. 6d. A disruption of the sterling-rupee rate was however threatened on March 31, 1941. Owing to the continued difficulty of securing shipping space export bills were few and far between. On the other hand, private remittances were on a fairly substantial scale. In other words, there were abundant buyers of sterling and very few sellers of sterling and it appeared as though for want of cover the rupee rate would break down. The Reserve Bank, however, prevented the exchange from deteriorating by offering to sell Reverse Council Bills at 1s. 5-31/32 d.

Kong, Malaya, Netherlands and East Indies and British possessions in Burma were similarly frozen.

Repatriation of Sterling Debt. As the result of a very favourable balance of trade, a large sterling balance accumulated in the hands of the Reserve Bank. This surplus was used for the repatriation of the sterling debt of the Government of India which had been reduced from Rs. 396·5 crores in 1938-39 to Rs. 14 crores in 1943-44. Three methods were adopted for the repatriation of sterling. Under one method, the Reserve Bank was authorised to purchase Indian sterling non-terminable securities in the open market out of its surplus sterling balances and to transfer the securities so purchased to the Government for cancellation. In their place additional rupee paper of the ½ per cent and 3 per cent non-terminable loans was to be created from time to time. Another method was to offer the holders of all sterling loans the option of converting their holdings into rupee securities. The third method in which compulsion was used was employed in 1941. Under the compulsory scheme British Treasury issued a vesting order requiring all residents in the United Kingdom to surrender their holdings of India's terminable and non-terminable sterling loans and the Government of India issued a notification to the same effect requiring residents in British India to surrender their holdings of these sterling loans, payment being offered in rupee counterparts or cash at the holder's option. The combined use of the two methods enabled the Government to effectively repatriate more sterling debt than would have been otherwise possible. By these means the Government brought about an appreciable substitution of sterling liabilities to non-residents by rupee liabilities to residents which provided a valuable relief to their remittance programme. India's sterling debt and the amount of interest to be paid abroad each year had also been substantially reduced and the Home Charges which were an enormous drain on the resources of India virtually disappeared. The accumulation of huge sterling balances in London has proved extremely useful to Great Britain also. "It has played its part in contributing to the restoration of cheap money....................It has helped to swell the volume of funds seeking reinvestment in the long-term markets, and has thus assisted in maintaining the level of gilt-edged values. Finally, it has produced a considerable supply of funds for direct investment in Government securities of various forms and thus eased the task of bridging the gap between revenue and expenditure without recourse to inflationary borrowing".—*Economist.*

In simple terms India has contributed to three important features of the London Market, namely, (a) maintenance of cheap money ; (b) maintenance of gilt-edged prices ; and (c) facilitating the success of defence loans. Besides this repatriation of sterling loans, about 56 millions of sterling balances were also used to fund the sterling obligations in respect of Railway Annuities and repatriate Railway Debenture Stocks.

Apart from the embarrassment caused by the accumulation

of such large quantities of sterling in the hands of the Reserve Bank of India, the question of their utilisation created serious problems both for the Government of India and the Government of Great Britain, especially because responsible British statesmen like Winston Churchill suggested their total repudiation. The people of India naturally demanded that they should be permitted to use the sterling balances for the purchase of any amount of capital goods in any part of the world. The British Government, on the other hand, apprehending a total collapse of their economic system, insisted that sterling expenditure should be spread over a large number of years, and should be confined, so far as possible, to Great Britain alone. The question was likely to create a good deal of misunderstanding and ill-will between two Commonwealth countries both of which were equally eager to strengthen their ties of relationship. Hence, it was a good sign that the Governments of the two countries agreed to convene periodical conferences for the purpose of determining the amount of sterling releases on the part of the British Government.

Additional Taxation. To pay for the expansion and mechanisation of the Indian Army which was estimated to cost Rs. 20 lakhs per day[1] additional taxes were imposed in November, 1940 and March 1941. The Supplementary Finance Bill of 1940 imposed a 25 per cent surcharge on all taxes on income and increased letter postage, telegram and telephone charges while the budget of 1941 increased the Excess Profits Tax and imposed an extra duty of Re. 1 per cwt. on sugar and of two annas per gallon on petrol. It also provided for a surcharge of one anna per rupee on passenger fares. In 1942 the E.P.T. was increased from 50 to 66⅔ per cent. Central surcharge on the income tax and super tax was raised from 25 to 33⅓ per cent. The excise duty on matches was increased by 100 per cent and a new excise duty of 10 per cent *ad valorem* was imposed on tyres and tubes. In 1943 the surcharge on income tax and super tax was graded and the Corporation Tax increased from one anna to 1½ anna per rupee of corporate profits. A surcharge of 25 per cent was imposed on import duties and the postal, telegraph and telephone rates were increased. Income tax and super tax rates were increased in 1944 and in the same year new excise duties were imposed on tobacco and vanaspati. The following table will give an idea of the total amount of revenue received by the Government of India year

1 The following figures should give a good idea of the increase in Defence Expenditure :—

[In lakhs of rupees]

1939-40	1940-41	1941-42	1942-43	1943-44	1944-45	1945-46 (Estimate)
49,54	73,61	103,93	238,89	199,60	466,64	411,99

by year.

[In lakhs of rupees]

	1939-40	1940-41	1941-42	1942-33	1943-44	1944-45	1945-46
Amount collected	86,93	91,75	123,85	151,51	195,04	356,88	353,74
Increase over 1939-40 ...	...	4,82	36,92	64,48	108,11	269,95	266,81

It will be noticed that the total amount raised from additional taxation was Rs. 484,28 lakhs by 1944-45 and it was expected to increase to 751,09 lakhs by 1945-46.

Defence Loans. Unable to make their both ends meet, the Government of India floated Defence Loans on June 4, 1940. These loans consist of 3 per cent Defence Bonds, Defence Savings Certificates and a Three-year Interest Free Loan. The 3 per cent Defence Bonds have met with a good reception, the total amount subscribed upto November 30, 1940, being over Rs. 30 crores of which Rs. 17 crores were subscribed in cash and Rs. 13 crores in conversions. The total subscription to the 10-Year Savings Certificates totalled more than Rs. 1·1/2 crores on the same date. Another innovation was the introduction of the Defence Savings Stamps of Re. 1, eight annas and four annas and of cards to which stamps were to be affixed to facilitate the collection of small subscriptions. The fourth Defence loan, *viz.*, the 3 per cent loan 1953-55 was issued on July 3, 1943 and closed on March 31, 1944. The 3 per cent Victory Loan, repayable at par on September 1, 1957, was issued on April 1, 1944 and is at present on tap. The Post Office Ten-year Defence Savings Certificates were replaced from October 1, 1943, by the more attractive Twelve-year National Savings Certificates, particularly to appeal to the small investor. The Five-year Interest Free Prize Bonds, in denominations of Rs. 100 and Rs. 10 repayable on or after January 15, 1949, were made available from January 15, 1944. The bond holders (winners) received half-yearly prizes. Between July1943 and June 1944, the total amount raised through all new issues and sales of loans on tap came to Rs. 283 crores. This had not only brought in more money to the Government but had also an anti-inflationary effect by absorbing the surplus money of the small investor.

Price Movements. All the developments referred to above, *viz.*, increase of currency and credit, fresh taxation and Government borrowing, etc., tended to have inflationary effects and in spite of a substantial increase in commercial and industrial activity prices in India increased more than in many other countries. This is amply

borne out by the following figures :

Countries	1939	1940	1941	1942	1943	1944	1945	1946	1947
Iraq	100	...	...	...	692	...	...	...	...
India	100	114	148	180	318	288	290	328	374
U.K.	100	142	155	161	167	164	174	180	189
Canada	100	111	124	128	140	136	141	148	164
Australia	100	113	18	135	138	137	140	140	142
S. Africa	100	112	120	134	154	150	...	...	...
U.S.A.	100	103	119	130	135	133	168	158	186
France	100	...	...	...	249	...	...	...	...
Germany	100	103	104	107	109	108	...	...	...
Japan	100	108	111	122	144	157	...	...	...

We shall first trace the course of prices in India during the War and then explain the measure adopted by the Government for controlling them.

The first four months of the War witnessed great activity in almost all the branches of national economy. The demand for raw materials was unprecedented and the prices shot up as the following figures will show :

		Calcutta	Bombay	Karachi
August	1939	100	103	104
December	1939	137[1]	135	121

Various reasons were attributed to this sudden rise of prices. Some held that the rise in the prices of essential commodities like jute and cotton, and perhaps silver, was the direct cause of the rise in the prices of all agricultural products, while others maintained that a rise in the prices of agricultural products like wheat and cereals caused by unseasonable rainfall helped to bring about a rise in the prices of other commodities. The more reasonable explanation, however, seems to be that war created an abnormal demand for many commodities which was stimulated by their prospective shortage. A vicious circle set in, in the form of rising prices and increased hoarding of consumer's stocks, and the sellers exploited the situation to their advantage. In other words, the rise of prices in many cases was due to *speculation* and *profiteering*, except perhaps in the case of imported articles the higher prices of which could be accounted for to some extent, by higher freight and insurance charges.

1 The rise was uneven as the following figures will show :

137—General index of primary commodities.

142—Index of manufactured articles.

125— „ „ food and tobacco.

184— „ „ other agricultural products.

133— „ „ raw materials.

The rising prices stimulated production. Exports increased and there were signs of plenty and prosperity among the masses. But in January 1940 there was a pause. Prices ceased to advance and in fact certain commodities registered mild decline, *e.g.*, jute, cotton, and linseed. In February there was a sharp set-back to which the Extra Profits Tax and the bogey of price control contributed. But it was anticipated that recovery was only a question of time and that it was bound to come. But in March and April prices fell still further owing to export restrictions.[1] In September the prices looked up again for the first time. The improvement did not extend to all commodities and in fact in certain cases the prices still showed a downward tendency but the all commodities index number increased to 121 in October 1940. In the case of precious metals, on the contrary, the prices showed a persistent rise. Gold touched a new high rate at Rs. 47-15-0 per tola and there was such a great demand for sovereigns that their prices were even quoted at 5 per cent more than their bullion value.

Throughout 1941 prices continued to rise and in the month of December, when Japan entered the War, the index number stood at 141. The prices of manufactured goods rose more than the prices of primary products and foodgrains. In December 1942 the index number touched 180 and in December 1943, 318.

Many eminent persons investigated the causes of such an unprecedented rise of prices. Mr. C. N. Vakil[2] and a number of other Indian Economists were of the opinion that the rise was due to the fact that the Government of India was issuing notes in India in order to enable the British Government to pay for its purchases in India. Since the creation of this additional currency was not accompanied by a corresponding increase in trade or industry, the result was inflation of a very bad type. Mr. G. D. Birla,[3] on the other hand, refused to admit the fact of inflation because while the amount of currency in circulation had increased there was a substantial decrease in the velocity of circulation of money and credit[4] and in the percentage of

1 For a war period commodity markets were at low levels. Jute fell to Rs. 65 a bale compared with Rs. 125 per bale as in December, 1939, cotton to Rs. 263 per candy from Rs. 333 per candy, linseed to Rs. 7-8-0 per maund from Rs. 10 per maund. The general index number fell from 130 in January 1940 to 121 in April, 1940.

2 *Falling Rupee.*

3 *War Finance,* especially the second essay—Scarcity or Inflation.

4 *Table showing a decrease in the velocity of circulation of credit.*

Year	Clearing House (in crores of Rs.)	Demand Liabilities (in crores of Rs.)	Velocity of credit
1938-39	1,929	124	16
1939-40	2,211	133	17
1940-41	2,019	155	17
1941-42	2,569	202	13
1942-43	2,778	308	9

advances and bills to liabilities.[1] He attributed the rise of prices to the scarcity of consumers goods. The shortage of foodgrains was due to the fall of Burma, Malaya, etc., in enemy hands and the excessive exports of Indian foodstuffs to Iran, Iraq, Ceylon and South Africa. Manufactured goods were scarce on account of the difficulties of transport and because the bulk of the goods manufactured in India were carried away by the United Kingdom Credit Corporation for the use of the Allied armies. The Government put the blame on the speculators, hoarders, and profiteers whom Dr. P. J. Thomas called Public Enemy Number One. The public on the whole felt that the Government itself was responsible for the rise of prices because while it had done little to increase the industrial and agricultural productivity of the country it was drawing largely upon the meagre resources which should have been left for civilian use. The Government was also guilty of failure to enforce "blanket controls" as in other countries and of the belated attempts to introduce rationing.

Price Control. We have seen that during the six years of War prices of many common necessities of life had gone up considerably. The rise was particularly sharp in the case of imported articles like chemicals, patent medicines, tinned provisions, toilet requisites, etc., while commodities like meat, grain and sugar which are produced locally also recorded substantial increases. There was nothing to justify the rise of prices in many cases. Stocks of commodities were normal, export was not permitted except under licence and internal transport conditions were satisfactory. The Defence of India Ordinance, 1939 and the Defence of India Rules drawn up thereunder had empowered the Central Government to make provision "for controlling the prices at which articles or things of any description whatsoever may be sold." The Governments were also authorised to delegate these powers to the Provincial Governments if desired. The Provincial Governments were accordingly authorised (under Notification dated 8th September, 1939) to fix limits to the extent of the rise of prices at each stage of the productive process, in the case of necessities and in particular of medical supplies, foodstuffs, salt, kerosene and the cheaper qualities of cotton cloth. The minimum price in each case was not to be less than 10 per cent above the prices ruling on September 1, 1939[2]. All the Provincial Govern-

1 *Table showing a decrease in the percentage of Advances and Bills to Liabilities.*

Year	Demand Liabilities.	Time Liabilities.	Percentage of Advances and Bills to Liabilities
1939-40	Rs. 140 crores	Rs. 106 crores	53
1942-43	" 431 "	" 134 "	26

2 The general principles underlying this policy were contained in a Memorandum

(Continued)

ments took immediate action for controlling prices. The major lines of action were similar in all cases although minor details of procedure and administration varied as between individual provinces.

Almost all Provinces appointed Controllers of Prices at Headquarters and empowered Deputy Commissioners and Collectors in charge of Districts to act as local controllers in respect of the areas within their jurisdiction. Both the Provincial and the District Controllers were to be assisted by Advisory Boards of Price Control Committees whose composition varied according to whether it was a Provincial or a District body. For the Provincial Committees, persons representing the interests of the agriculturists and industrial workers were also included. The function of these Committees was to advise the Controllers of Prices to keep Government in touch with the trend of trade and the difficulties experienced by traders and manufacturers and generally to keep Government in touch with the situation as it developed locally. Both prior to and after the appointment of these Committees comprehensive Press notes were issued noting the commodities the prices of which were to be controlled and warning dealers that anybody charging higher prices would be prosecuted. Hoarding or refusing to sell was also to be punished. Purchasers were advised to demand bills for all articles bought and in cases where it was felt that excessive prices were being charged, to report the same to the police.

The Government of India also convened two conferences of the representatives of all Provincial Governments and Administrations in India to discuss questions connected with price control. At the first of these Conferences held in Delhi in October 1939, the view was largely held that, so far as agricultural produce was concerned, it was undesirable to check the rise in prices at any rate at that time. At the second Conference, which was held in January, 1940, one of the conclusions reached was that in all places where effective control had been established there had been a tendency for supplies to dry up or to go underground and for normal business to be dislocated and it was decided that it would be unfair when the agriculturist was making some little profit to put the screw on him and fix an upper limit for the prices of commodities. This Conference also agreed to the desirability of the Central Government taking in hand the work of co-ordinating price control policy of the Provinces. It was decided that at the stage of production and with reference to the wholesale markets of some of the principal commodities, the Government of India should be the proper authority for limiting, should occasion

(*Continued*)

prepared by Dr. Gregory, our Economic Adviser. No increase of price was to be permitted unless it was justified by increased cost. In other words, increase of price caused by intensification of demand and shortage of supply or communication was to be prohibited except in the case of agricultural staples of our export trade whose price was not to be controlled. In the case of war materials the position of the Government as by far the most important customer, will lead to a process of bargaining which obviated the need for control.

arise, the price of such commodities and that at the retail stage the Provincial and State units should have complete freedom to fix maximum prices such maxima being fixed on the basis of the wholesale prices by the Government of India.

It was realised at an early stage that world prices of foodstuffs would rise rapidly and that this would have its repercussions everywhere. Nevertheless, the Government of India were determined not to interfere with the prices of agricultural produce because it was felt that such interference would deprive the cultivator of a golden opportunity to recover from the effects of the economic depression. It was also argued that the prices ruling before December 1939 were not really fair prices. The case of manufactured articles, however, was slightly different. Imported articles of general consumption were few, *viz.*, cotton goods, kerosene and medicines, and their prices could be easily regulated. Hence the attempts of the Government were largely concentrated on imported articles of general use.

This policy, however, did not prove very effective and the people had to pay more for almost everything. Most articles, and especially those whose prices were attempted to be controlled by the Government, went into the black market and were available to those only who were prepared to pay fantastic prices. This meant great misery and privation for the masses but nobody realised the gravity of the situation until millions of people died in Bengal and South India for want of food and clothing. After this severe calamity the Food Department was set up in December, 1942 to enforce price control and to arrange the supply and distribution of foodgrains. From January 1943 it took over from the Supply Department the task of procuring and purchasing the food requirements of the Army. It also prepared a plan for the procurement, transport and distribution of foodgrains from the surplus to the deficit provinces. A Central Food Advisory Council was formed in July 1942 to devise ways and means of growing more food all over the country. The Government also appointed the Foodgrains Policy Committee in July, 1943 and acting on its recommendations the Government arranged to import 80,000 tons of foodgrains from abroad and subsidised the farmers to bring new lands under the plough. Rationing of food and clothing was introduced in many urban areas and the prices of other articles were brought under control.

Failure of price control may be attributed to many causes. Very few people understood or appreciated the principle on which the controls were based. It was widely recognised that prices were the external manifestation of numerous forces working within the economic system ; yet few people demanded the control of those forces which form prices themselves. Only after a fairly long record of failure was it realised that controls over supplies and distribution are essential and vital corollaries of price control. Moreover, a successful policy of price control presupposes not only an effective machinery of control but also a clear conception of fair price and

the establishment of suitable parities between different groups of prices. It also requires the determination of the number and range of prices that have to be brought under control. Unfortunately these conditions were completely ignored in India. No attempt was made to calculate the farmers' costs or to relate their prices to those of manufactured articles etc. "The large size of the country, the small, individualistic and unorganised character of production and trade agencies and the very large number of small agricultural producers whose operations are not easy to bring under control" made effective controls difficult. Lastly, the uncongenial political, psychological and monetary set-up of Indian war economy presented insuperable difficulties for the Government. For instance, the vicious spiral of rising prices engendered by the inflationary expansion of currency could not be arrested so long as the war lasted. Nor could the problems of production and transport be solved in a short period. There was little co-operation from the people who went on indulging in speculation and minting money in the black-markets without the least qualm of conscience.

Even when the War was over the prices did not move down. It was expected that the reduction in the volume of demand for Defence requirements, the availability of larger industrial capacity to the civilian sector of the economy and the augmentation of supplies in certain lines through imports would help to improve the supply position and lower the level of prices. Contrary to these expectations, however, the inflationary conditions were intensified by the operation of other causes, such as the inadequacy of capital equipment and lack of trained personnel, the reduction in working hours and the countrywide strikes and civil commotion and bottlenecks in internal transport and distribution which accentuated the prevailing scarcities. Production of iron and steel, sugar, cotton textiles, cement, paper, etc., recorded a decline. There was also a decline in domestic production of foodgrains occasioned by famine conditions ; failure of crops in some areas and the irregularity in the arrival and inadequacy of foreign imports contributed to render the food situation grave. Price controls were continued through emergency legislation in respect of foodstuffs, edible oils and oil-seeds, cotton and woollen textiles, paper, petroleum, coal, iron and steel and mica. The decontrol of the rest of the commodities in the context of the conditions mentioned above actually tended to raise their prices. Another contributory factor was the addition to wages and allowances conceded in certain industries in response to the demands of labour. Besides, there was also the influence of international forces, such as the rise in the price-levels in the U. K. and the U. S. A., the persistence of demand from markets opened during war-time and the general prevalence of conditions of a sellers' market abroad, all of which helped to bring about a rise in the prices of industrial raw materials. The concrete remedial action taken by Government in this sphere related to the appointment in February, 1946, of the Commodities Prices Board to advise them in the formulation and administration of an appropriate and consistent price

policy. The main function of the Board is to keep under constant review the movements of commodity prices and to advise Government on price controls in respect of controlled commodities and on the question whether other commodities should be brought under control.

For countering inflationary tendencies Government adopted measures partly to draw off the excess purchasing power in the hands of the community and partly for increasing the production and supply of goods. For the purpose of increasing the supply of goods two committees were set up in 1947 to devise ways and means of expediting the cancellation of the pending war contracts and releasing for civilian production and consumption the country's limited resources of productive capacity and essential raw materials, the contracts in respect of war-like stores actually cancelled up to March, 1947 being of the value of about Rs. 23·5 crores. Measures were also taken to feed the main stream of supplies with a part of the large quantity of stocks including American surpluses held by the Defence Department. Government also set up a development wing in the reconstituted Department of Industries and Supplies to expedite reconversion of industry to civilian production by according necessary priorities and transport facilities. The policy and procedure relating to the issue of licences for imports from hard currency countries were greatly liberalised. With the expiry of the Defence of India Act on 30th September, 1946 majority of wartime emergency measures were allowed to lapse excepting certain essential general controls such as those over Capital Issues, imports, exports and foreign exchange and some over the production, supply and distribution of certain essential commodities.

Conclusion. From the foregoing survey it will be seen that the Indian monetary system stood the strain of the War remarkably well. After the inevitable dislocation in the first few weeks of the War, the system quickly adjusted itself to the changed conditions and withstood the worst shocks of the War. The transition from a peace economy to a war economy was effected in a much shorter time and with considerably less dislocation than during the first War. The strain it put on the Indian financial system was indeed severe, but the history of the last six years proved beyond doubt that it had emerged with its strength unimpaired. The indigenous industries received considerable impetus and the credit balances accumulated in England should enable many more industries to come into prominence after the War.

The Present Currency System of India. It has the following outstanding features :-

1. The sole right of note-issue is vested in the Reserve Bank of India and is exercised through the Issue Department which is wholly distinct from the Banking and other departments of the Bank.

2. According to the Reserve Bank Act, the assets of the Issue Department are to consist of not less than two-fifths of gold coin, gold bullion, or sterling securities, provided that the amount of gold is not less than Rs. 40 crores in value. Of the gold coin and gold bullion, not less than 17/20ths is to be held in India. The remaining three-fifths of the assets might be held in rupee coin, Government of India rupee securities of any maturity and such bills of exchange and promissory notes payable in India as are eligible for purchase by the Bank, provided that the rupee securities do not exceed one-fourth of the total amount of the assets or Rs. 50 crores whichever amount is greater. Gold is to be valued at par *i.e.*, 8·47512 grains of fine gold per rupee, rupee coin at its face value, and securities at market rates.

Today, more than half the note-issue is covered only by sterling securities which are, for all practical purposes, unrealisable as the following figures will show :—

[In crores of rupees]

Year	Total notes Issued	Gold coin and bullion	Sterling securities	Rupee coin	Rupee securities
1938-39	210	44	67	67	32
1947-48	1274	44	1135	32	63
1948-49	1258	42	907	43	266
1949-50	1153	40	647	51	415
1950-51	1180	40	625	57	458
1951-52	1217	40	625	64	488
1952-53	1142	40	564	80	458
1953-54	1156	40	594	93	430

Nevertheless, the present position is much better than what it was in 1947-48 when Rs. 1135 crores out of Rs. 1274 crores of notes were backed by sterling securities only. The above figures will also show that while the amount of sterling securities is gradually going down, the amount of rupee securities is steadily going up.

3. The Reserve Bank is also required by law to supply different forms of currencies, *i.e.*, it has to issue rupee coin on demand in exchange for bank notes and curreney notes of the Government of India and to issue currency notes or bank notes in exchange for coin which is legal tender.

4. According to an amendment made in the Indian Coinage Act in April 1947, the silver coin has been replaced by the nickel rupee. The rupee has long been known to be an inconvertible note printed on silver. Today it is printed

on nickel. Similarly, the silver contents of 4-anna and 8-anna coins have been reduced from 11/12 to ½ fine.

5. Rupees and notes are unlimited legal tender. Internally they are convertible into each other. Hence, the old anomaly of one kind of inconvertible money being convertible into another continues.

6. There is very little deposit currency which every modern country tends to develop with the development of trade and industry as the following figures will show :—

End of	Japan (Billions of Yen)			India (Billions of Rupees)			United Kingdom (Billions of Pounds sterling)			United States (Billions of U.S. Dollars)		
	Currency	Deposit Money	Total	Currency	Deposit Money	Total	Currency	Deposit Money	Total	Currency	Deposit Money	Total
1938	3	5	8	3·0	1·4	4·4	0·46	1·19	1·64	5·8	26·0	31·8
1945	55	38	93	13·1	7·4	20·5	1·34	3·07	4·42	26·5	75·9	102·4
1948	338	331	669	12·9	7·4	20·6	1·25	3·87	5·12	26·1	85·5	111·6
1949	336	434	770	12·1	6·7	18·8	1·27	3·92	5·19	25·4	85·8	111·2
1950	409	511	920	12·7	6·7	19·4	1·29	3·99	5·28	25·4	92·3	117·7
1951	492	701	1,193	12·4	6·4	18·8	1·36	3·99	5·36	26·3	98·2	124·6

7. The existing monetary system lacks elasticity. It does not allow the money in circulation to expand and contract with the varying needs of trade and industry. What is still worse, while the expansion of currency is easy, contraction presents numerous difficulties.

8. The Reserve Bank is also required to maintain the ratio of 1s. 6d. Before 1945, this function was regulated by clauses 40 and 41 of the Reserve Bank Act. Consequent on India's membership of the I.M.F., and the fixing of par values in accordance with the Articles of the Fund Agreement, sterling ceased to be the sole determinent of the external value of the rupee. The convertibility of the rupee into other currencies was, therefore, provided for by the enactment of the Reserve Bank of India (Second Amendment) Act, 1947 which was passed by the Central Legislature in April 1947. The amendment repealed Sections 40 and 41 of the Reserve Bank of India Act which had obliged the Bank to buy and sell foreign exchange at such rates and on such terms and conditions as the Central Government may determine in conformity with their obligations as a member of the I.M.F.

9. This does not, however, mean that the rupee has now no connection with sterling. On the other hand, so long as India is a member of the British Commonwealth complete divorce between the two currencies is inconceivable. The consequence of this relationship was apparent in 1949. Closely following the decision of Great Britain to devalue sterling in terms of the U. S. dollar, the Government of India also devalued the rupee and thereby changed the par value of the rupee in terms of the U. S. currency from 30·225 cents to 21 cents and in terms of gold from 0·268601 to 0·186621 grammes of fine gold to the rupee. The devaluation of the rupee raised prices in India and increased the cost of articles imported from outside the sterling area.

10. It is highly significant in this connection to remember that Pakistan, although a member of the sterling area, did not devalue her currency at all with the result that her currency appreciated both in terms of the Indian rupee and the pound sterling. To be more exact, after 1949, 100 Pakistani rupees became equivalent to 144 Indian rupees and the trade between the two neighbouring dominions was badly interrupted.

11. According to the Reserve Bank Act, when the Bank is of the opinion that the international monetary situation has become sufficiently clear and stable to make it possible to determine what will be suitable as a permanent basis for the Indian monetary system and to frame permanent measures for a monetary standard it shall report its views to the Central Government. The Bank has not made any such report so far. Evidently the international situation is still far from clear and does not warrant any change in the Indian currency system.

SUMMARY

The War had profound effects on the currency and prices in India. In the beginning there was panic leading people to withdraw their deposits from banks and to present their notes for encashment but confidence was soon restored. But the hoarders of rupee coins presented serious difficulties especially at a time when the demands for currency had so enormously increased and the Government were forced to ration the issue of rupee coins.

In order to meet the increasing demand for money, the Government put into circulation one rupee notes and new 4-anna, 8-anna, and one-rupee coins—the coins containing a larger percentage of baser metals than before. The old Queen Victoria rupees were withdrawn and the silver thus obtained was used for manufacturing new coins. By these means the Government were able to expand currency to the extent of Rs. 882 crores between September 1939 and March 1944.

On account of the peculiar conditions created by the War, the balance of trade became favourable. Some import and export restrictions also became necessary—the former to prevent the import of luxury goods and the latter to conserve the supplies of all essential commodities for the Allied countries.

The Government also thought it necessary to control all dealings in exchange. As the U.S.A. was the largest creditor country, the Reserve Bank adopted several

measures to ensure a regular remittance of money to that country and private remittance was entirely prohibited.

As a result of a very favourable balance of trade a large sterling balance accumulated in the hands of the Reserve Bank. The opportunity was utilised for paying back a large part of our national debt and for converting sterling loans into rupee loans. The War also necessitated additional taxation and fresh loans.

The effect of all the measures described above was to raise prices. The prices in India rose more than the prices in other countries and in many cases they were beyond the means of ordinary men. Attempts at controlling prices merely drove articles into the black market and in Bengal and South India the shortage of consumers' goods became so acute that millions of people died for want of food and clothing. With a view to increasing the supply of foodgrains the Government launched the Grow More Food Campaign and arranged for more supplies from abroad. Prices of other goods were also more effectively controlled and rationing of food and cloth was introduced in important towns.

The important features of the currency system as it exists at present are given below :—

1. The right of note-issue is vested in the Reserve Bank.

2. The Reserve Bank Act has prescribed the percentages of notes which can be backed by gold, rupee coin, sterling and rupee securities.

3. The percentage of sterling securities in the reserve is still high, although it is being gradually replaced by rupee securities.

4. The Reserve Bank is also required by law to issue currencies other than bank notes.

5. The silver rupee has been replaced by a nickel rupee which is freely convertible into paper notes only.

6. Unlike foreign countries, deposit money has not yet been sufficiently developed in India.

7. Present currency system, therefore, lacks elasticity.

8. The Reserve Bank is required to maintain the exchange rate of 1s. 6d.

9. Consequent on India becoming a member of the I.M.F., the rupee has been linked to gold, although indirectly.

10. Nevertheless, it has links with sterling also and these links will continue to be important so long as India is a member of the British Commonwealth of Nations.

11. Indian currency was devalued in 1949. This was a proof of India's continued associations with British sterling.

12. The world situation is neither sufficiently clear nor sufficiently stable to mint any change in the Indian monetary system.

QUESTIONS

1. How has the currency system of India been affected by the present War? What steps have been taken to cope with the difficulties experienced in the management of currency and exchange since September 1939?

[Agra B. Com. 1941]

2. Trace the course of prices in India since September 1939 and explain the steps taken by the Government for controlling prices.

3. Write notes on :—

(i) Exchange Control—(See Chapter VIII).

(ii) Repatriation of Sterling.

APPENDIX TO CHAPTER XIII

DEVALUATION AND REVALUATION OF THE RUPEE

At the end of Chapter XI it was pointed out that just before the second World War a very strong body of opinion favoured 1s. 4d. as the appropriate exchange value for the rupee. The circumstances created by the War, however, changed the position a little. The balance of trade became favourable to India and a large amount of foreign exchange became readily available. As a matter of fact, the sterling accumulations became so heavy that, when as a member of the I.M.F., India was called upon to declare the rate of exchange for the rupee in terms of gold, she unhesitatingly chose the rate of 1s. 6d. But the sudden decision of Great Britain to devalue the pound sterling compelled the reopening of the controversy which was dead and buried during the war period. With the sterling divorced from gold, the question was no longer whether India should or should not maintain the old rate of exchange of the rupee, but whether the rupee should continue at the old rate with those currencies which had devalued or with those which had not. India decided to maintain the old rate with sterling which meant a devaluation to the same extent as the sterling in terms of the dollar (and gold). Let us try to understand the implications of this decision and its repercussion in the light of subsequent developments. The discussion will be preceded with a brief exposition of the theory of devaluation.

The Theory of Devaluation. In recent years, particularly since the emergence of the International Monetary Fund, the tendency has been to have fixed exchange rates. A revised exchange rate fixed at a lower level constitutes, under the circumstances, devaluation.

Devaluation is a remedy for correcting an adverse balance of trade and payments. It stimulates exports by making them 'more paying'. It reduces imports by making them 'more costly'. Thus it leads to adjustments without which maintenance of a fixed exchange rate would be difficult.

An adverse balance of payments (trade and other accounts) has under the economic allopathy a number of other remedies such as deflation, restriction of imports etc. Deflation, through reduced Government Expenditure, increased borrowing programmes, increased Bank rate and the like, can cause a rise in prices and incomes and thereby lead to an increase in exports and reduction in imports. But deflation leads to unemployment and suffering and is, therefore, discredited. The other method is a direct restriction of imports. The device provokes retaliation and hás its manifold limitations. It

may be mentioned that Britain, before 1949, was planning to adopt this last device to fill in her chronic balance of payments gap. An integrated programme incorporating all the three methods mentioned above can restore equilibrium in the balance of payments very quickly and without serious after-effects.

It may be noted that a proper exchange rate should be in harmony with the purchasing power of the currency units. It should, in fact, be the ratio between the two. This simple principle, however, becomes highly complex because fool-proof devices of comparing purchasing powers are lacking. We can illustrate the truth underlying it as follows :—

Suppose article Z is available in Britain for £1 and in U.S.A. for $2·80 and the £ : $ rate is £1=$4·03. This exchange rate looks quite unnatural. If Z is a representative article, it will mean that England will be importing far in excess of her exports. Imports are ultimately financed by exports and so who can operate at this rate ? Obviously no one, unless England continues to receive aid and loans from U. S. A. What is the way out ? One method would be to reduce its prices so that there is purchasing power parity. This is deflation. Another method would be to reduce the exchange rate of the £ to $2·80. This is devaluation. Suitability of an exchange rate is not judged in practice as above because of difficulties hinted to earlier—though smooth international trade requires that there is no major deviation from it in the long run. Nowadays a general rule is followed : that rate is good which balances a country's balance of trade and payments. Obviously different rates may have to be tried to maintain this equilibrium. Great Britain, as we shall presently see, resorted to this expedient in 1949. She had primarily two objectives in view in the devaluation of the pound sterling in terms of the dollar. Firstly, it desired to stimulate exports to dollar areas ; secondly, it wanted to increase the competitive strength of the British manufactures both in the dollar as well as in the sterling areas. The ultimate goal through the fulfilment of these objectives was the same ; balancing of its chronic adverse balance of payments.

Devaluation by increasing the cost of imported articles encourages a rise in the internal price-level. Herein lies its greatest danger. If the price-level rises in proportion to devaluation, then obviously devaluation fails to achieve its purpose. To cash the fruits of devalution it is, however, essential to check this rise through rigid price controls, improved productivity and mild deflation. If exports are absolutely inelastic, devaluation would serve little purpose. It is only when the quantum of export increases more than proportionately to devaluation that devaluation can normally be attractive. Colin Clark determined elasticity of demand of British exports to dollar areas at 2 and recommended in June 1949 devaluation of the £ sterling to $2·50. Though Britain did not devalue so low, it has actually been able to sell in dollar areas in a higher proportion to devaluation.

Devaluation, unaided by appropriate measures, cannot permanently cure the disequilibrium between debtor and creditor nations.

The Arithmetic of Devaluation. On 19th September, 1949 Britain reduced the sterling-dollar exchange rate from £1=$4·03 to £1=$2·80 (two dollars and eighty cents). This is the famous devaluation by which pound sterling for long the ruling monarch of world currencies and still second in importance to the dollar, lost 30·5% of its exchange value.

The Indian Rupee has been tied to the £ sterling since 1927 at Re. 1=1s. 6d. It has been directly linked to the $ at rates corresponding to the above ratio. The rupee-dollar exchange rate and the method it was arrived at before devaluation were as follows :-

£ sterling=$4·03 *i.e.*, 240d.=403 Cents.

1 Rupee=1s. 6d.=18d.=18×403÷240 Cents=30·225 Cents.

When Britain devalued, India followed suit. India also devalued the rupee proportionately with respect to the dollar, maintaining thereby intact the rupee-sterling ratio. The rupee-dollar exchange rate and the method by which it was arrived at after devaluation were as follows :—

£1=$2·80 *i.e.*, 240d.=280 Cents.

1 rupee=1s. 6d.=18d.=18×280÷240 Cents=21 Cents.

Presuming dollar prices to remain constant, imports from dollar area were likely to sell at (app.) 44% higher price in India. With the same assumption our exporters were to get 44% more rupees in exchange due to devaluation on account of their dollar earning. Presuming further rupee prices to remain constant, our exports could be sold in dollar areas at 30·5% reduced dollar prices.

Indian Decision : Pros and Cons. Our external trade has long been associated with the sterling area. For 1948-49, the volume of our trade with the sterling area comprised Rs. 592 crores as against Rs. 262 crores with the hard currency areas. While devaluation was expected to increase our cost of imports from hard currency areas, non-devaluation would have increased them with respect to sterling areas. Further a stimulus to exports in hard currency area through substantial devaluation had long been called for, whereas it was inadvisable to let the sterling price of our exports rise. Apparently, therefore, it was advantageous for us to keep company with Britain. If we did not devalue, we should have got sterling goods cheaper (unless new export duties were imposed by countries devaluing) though we would have lost some of our markets in the sterling area. Our market in dollar areas would also have suffered because of competition from countries which had devalued. This would have reduced our foreign exchange earnings, adversely affected our economy, and worsened our balance of payment situation.

India had no legal obligation to devalue proportionately or devalue at all after the devaluation of the sterling. The legal link of 1s. 6d. fixed in 1927 had been suspended by an Act of 1947, and the

Government was legally free to adopt any ratio it liked. Actually the Government did not interfere with the ratio at all ; it preferred to maintain the *status quo* in relation to Great Britain.

Till the eve of devaluation, we had borrowed $44 million from the World Bank and $100 million from the I.M.F. Pre-devaluation and post-devaluation rupee equivalent of this total debt was Rs. 47·64 crores and Rs. 68·57 crores respectively. Hence the rupee liability was greater by Rs. 20·93 crores. But India had to depend more and more for its requirements of capital goods and food on sterling areas although it could not avoid importing some machinery, raw materials and other essential material from the dollar areas also. The increased cost of the imports were bound to react adversely on our replacement programmes and capital projects. It must, however, be remarked that Britain was still our chief supplier of machinery and so the adverse reactions were not likely to be grave. Again it was possible to meet most of our food deficits—luckily diminishing—from sterling areas alone.

Prices in India had increased considerably since the war as compared to U.S.A. and Britain. The wholesale price index with 1937 as the base in 1949 was 354, 180 and 213 respectively for these countries. The price of export goods in India similarly showed a far greater increase as compared to that of U.S.A. and Britain. Accordingly the pressure for proportional devaluation would have been great if we had devalued less or not devalued at all. It may also be mentioned that India on account of her sea-borne trade in 1948-49 had a deficit of Rs. 95 crores and Rs. 423 crores respectively. The pressure for devaluation was obvious, it was a most desirable defensive weapon under the circumstances.

Effects of Devaluation in General. As expected, devaluation brought about an improvement in the payments situation of the devaluing countries by an increase in exports and a reduction in their imports. To what extent this has been achieved will be evident from the following figures showing the export and import figures of Europe, Asia and Africa with the Western Hemisphere.[1]

(Value in millions of dollars)

Europe	*Monthly averages*	
	Exports	Imports
January—December 1948	197	553
January—September 1949	191	509
October—December 1949	194	388
January—March 1950	190	365
Non-European and Non-Western Hemisphere countries		
January—December 1948	178	279
January—September 1949	158	287
October—December 1949	149	222
January—March 1950	180	192

1 For further details read annual report of the I. M. F. for the year ended 30th April, 1950.

Moreover, the coincidence of the timing of devaluations with the recovery in the U.S.A. has kept to a minimum any disturbing effect the devaluations might have had on business activity in the U.S.A. This has been helpful, too, in providing a more favourable environment for the countries that devalued and for maintaining the dollar prices of raw materials produced by them.

The greatest value of devaluation, however, is psychological. It has given a shock to the people of many countries of Europe and made them realise the necessity of examining and tackling the economic problems at home.

Effects of Devaluation on India. So far as India is concerned, devaluation has brought many advantages as well as disadvantages. The balancing of these is not easy because the developments that followed devaluation were influenced by other factors as well and it is practically impossible to apportion the gains and losses registered by the country as between devaluation and the other factors. Take, for instance, the figures of foreign trade which are the most sensitive to changes in the external value of a country's currency.

In crores of rupees.

Period	Receipts	Payments	Net
1949			
1st Quarter	124·7	219·4	—94·7
2nd Quarter	131·5	201·9	—70·4
3rd Quarter	138·9	162·8	—23·9
4th Quarter	170·0	128·2	41·8
1950			
1st Quarter	169·2	139·4	29·8
2nd Quarter	140·0	160·7	—20·7

It is evident that our balance of payments position improved considerably by the middle of 1950. But it will be not logical to give the whole credit to devaluation alone for it is also a fact that the steps taken by the Government a few weeks before devaluation to reduce imports and stimulate exports have also been responsible for narrowing down the gap in our adverse trade balance.

Similarly, devaluation has provided an incentive to India to raise the production of its raw material and food badly needed by it although the fulfilment of this desire also has been rendered difficult by the increased cost of irrigation projects.

Measured by the modest rise in the index number of wholesale prices, it would appear that devaluation has not had any seriously

adverse effect on the economy of the country.[1] As a matter of fact, until June 1950, the general index number of wholesale prices remained more or less stationary. If price rose thereafter, the Korean War and the European Disarmament were really more responsible for it.

Index No. of wholesale prices (year ended August 1939=100)

		Food articles	Industrial Raw Material	Semimanufactured articles	Manufactured articles	Miscellaneous	General
March	1949	376·5	462·8	322·4	329·4	515·2	370·2
August	1949	410·6	460·5	330·8	348·6	541·6	389·0
October	1949	406·8	477·9	332·2	352·6	588·8	393·3
January	1950	379·1	486·2	335·5	344·6	614·9	384·7
February	1950	395·3	493·3	338·1	346·5	632·3	392·3
March	1950	396·2	490·1	338·2	347·4	630·6	392·4
April	1950	399·3	483·9	332·7	347·8	630·6	391·3
May	1950	401·6	486·4	335·0	348·3	620·6	393·6
June	1950	402·3	490·8	335·6	347·6	692·0	395·6
July	1950	422·8	506·0	339·6	348·2	708·9	405·2
August	1950	426·5	513·1	343·8	249·9	727·3	409·2
September	1950	430·4	517·1	346·9	350·4	760·8	412·5
October	1950	427·3	520·1	346·9	350·4	728·6	411·2
November	1950	424·3	522·0	347·9	349·5	744·7	410·9
December	1950	423·9	533·8	351·0	350·0	718·0	412·6
January	1951	413·5	552·0	358·8	353·5	701·1	414·3
February	1951	414·0	556·5	371·6	369·7	706·3	423·4
March	1951	412·1	610·5	381·3	387·3	763·4	438·7
April	1951	412·6	683·2	387·8	410·2	764·5	457·7
September	1951						435·1
November	1951						435·6

1 The credit for this also should go to the Government whose Eight Point Programme announced in Parliament on 5th October 1949, helped a great deal in holding the price-line and in conserving the country's resources in foreign exchange. The eight points were :—

(1) Formulation of the future pattern of trade so as to reduce expenditure of the foreign exchange to a minimum, having regard to the essential requirements of the country ;

(2) employment of India's bargaining power for the purpose of bringing down to reasonable level the prices of industrial materials imported from countries whose currencies had appreciated in relation to Indian currency ;

(3) prevention of speculative price increases by legislative and administrative measures and by regulation of credit facilities;

(4) imposition of customs duties, consistently with the principle of non-discrimination on articles exported to hard currency areas so as to ensure a maximum amount of foreign exchange for the country and at the same

(*Continued*)

It is also significant that, in spite of a rise in the cost of raw materials, the exports of Indian manufactured goods have not been handicapped to any marked degree. It has been so because the rise in the raw material cost of competing countries have been greater than in India.

Likewise, the Bombay cost of living index did not show any appreciable increase until July 1950 which shows that the internal price situation did not deteriorate until the far more important international factors clouded the effects of devaluation.

Bombay Working Class Cost of Living Indices.

(August 1939=100)

	1946	259	June	1950	312
	1947	279	July	1950	319
	1948	303	August	1950	322
April	1949	305	September	1950	323
May	1949	306	October	1950	319
June	1949	300	November	1950	312
July	1949	302	December	1950	310
August	1949	306	January	1951	318
September	1949	306	February	1951	321
October	1949	307	March	1951	322
November	1949	310	April	1951	335
December	1949	308	May	1951	335
January	1950	309	June	1951	337
February	1950	305	July	1951	333
March	1950	302	August	1951	328
April	1950	307	September	1951	325
May	1950	312	October	1951	332

(*Continued*)

time secure that the advantage resulting from devaluation was distributed among the foreign importer, the Indian manufacturer and the Indian exchequer ;

(5) action to further the stimulus to investment, which devaluation generally provides and thereby to assist production and promote development by an intensified savings drive by propaganda, and failing this by compulsion and by provision of suitable governmental assistance for the extension of banking facilities to rural areas ;

(6) extension of facilities for voluntary settlement of taxes payable in respect of war profits to assessees whose cases had not been referred to the Income Tax Investigation Commission ;

(7) introduction of economy measures for securing an aggregate reduction of approximately Rs. 40 crores in government expenditure for 1949-50 and not less than twice that sum for 1950-51 as compared with the budget estimates for 1949-50 ; and

(8) reduction of 10 per cent in the retail prices of essential commodities, manufactured goods as well as foodgrains, by a reduction of ex-farm and ex-factory prices or by reduction of distribution costs and incidental charges or by both.

For further details read Pp. 46-48 of the Reserve Bank Report on Currency and Finance for the year 1949-50.

Nevertheless, the effects of devaluation on the general economy of the country as a whole have by no means been as favourable as they have been in the case of other countries. Costs of living all over India in 1951 are higher than they were at the end of 1949. Prices of essentials as well as of non-essentials are also higher. Unemployment has also increased. Production is not as satisfactory as it should be and in fact threatens to go down. Supplies are scarce and, in an essential commodity like cloth, the scarcity is due to large exports in the face of declining production. The position of none of the European countries which devalued their currency is so bad as the following figures will show :—

Year & Month		United Kingdom		Australia		South Africa	
		Whole-sale Price	Cost of living	Whole-sale Price	Cost of living	Whole-sale Price	Cost of living
August	1949	211	179	190	164	193	159
September	1949	212	180	190	164	194	159
October	1949	218	181	193	168	193	159
November	1949	221	181	198	168	194	159
December	1949	222	182	203	168	194	160
January	1950	225	182	207	170	195	160
February	1950	225	182	210	170	196	161
March	1950	226	182	210	170	196	162

Although prices in these countries have also increased, the percentage of rise is small in comparison with India. Moreover, they do not suffer either from scarcity of goods or from unemployment. Indeed, the underlying object of devaluation by all these countries was the maintenance of a high level of employment. It was with this object in view that they preferred devaluation to deflationary measures and there is no doubt they have all succeeded in reaching that aim. They have, therefore, good reason to feel satisfied with devaluation but not so India where the problems of scarcity and employment have still to be solved.

There is another significant point worthy of notice. In India the advantages of devaluation have not been so sustained as they have been in the case of other countries. This is due to the fact that India has practically no exportable surplus of goods. Almost all the West-European countries have recovered their productive capacity, thanks to the generous assistance rendered by America, and have not only a surplus production on hand but also surplus productive capacity which they can exploit in order to avail themselves fully of

the opportunity offered by devaluation. In the case of India, however, the surplus available for export was limited and what little there was has since been practically exhausted. As regards expanding production, devaluation has been more of a handicap than of help. It has made it difficult and costly for India to get its essential requirements of capital goods, stores and raw materials. Perhaps, the position might not have been so difficult had there not been the deadlock with Pakistan.

The Indo-Pakistan Trade Deadlock. This brings us to easily the worst effect of devaluation, namely, the trade war with Pakistan. Pakistan refused to fall in line with Great Britain and other commonwealth countries. In other words, it decided not to devalue its rupee which, in the present context, means that it did not reduce its rupee-dollar ratio. Thus the Indian and the Pakistani rupees, moving in unison earlier, parted company so far as international value was concerned and the new rate of exchange between the two rupees became Rs. 100 (P)=Rs. 144 (I) calculated as follows :—

100 Pakistani Rupees = $100 \times 30{\cdot}225$ cents or
1 Pakistani rupee = 30·225 cents
But 1 Indian rupee = 21 cents
$\therefore$ 100 Pakistani rupees $= \dfrac{100 \times 30{\cdot}255}{21}$ or
144 Indian Rupees (approximately)

The parities of the Pakistani rupee in terms of gold and of the U. S. dollar were as follows :—

0·268601	grams of fine gold per Pakistani rupee.
115·798	Pakistani rupees per troy ounce of fine gold.
3·30852	Pakistani rupees per United States dollar.
30·2250	United States cents per Pakistani rupee.

The position taken up by Pakistan was dictated partly by considerations of prestige and partly by genuine recognition of the fact that its economic interest lay in maintaining the *status quo*. Pakistan's external trade prior to devaluation was about half with India. It was felt that the demand for its principal exports *e.g.*, raw cotton, jute and foodgrains to India had an inelastic demand and would bring, through non-devaluation, 44% more of Indian rupee exchange. On the other hand, it could get Indian imports 30·5% cheaper. Also, through non-devaluation it hoped to obtain 44% more of imports in physical terms than would be possible if it followed the Indian example. Thus, Pakistan not only showed keenness to maintain a new rate but also her old prices which made the position of other countries (particularly that of India with respect to jute and cotton) very complicated. India refused to accept this position and a trade deadlock ensued. The Indian Jute Mills Association suspended purchase of raw jute from Pakistan. In view of

the already large payments of deficit with Pakistan, action was also taken to restrict the scope of O.G.L.X. for imports from Pakistan to essential items such as fish, fruits and vegetables, milk and milk products. These measures resulted in a virtual stoppage of major parts of India's imports from Pakistan. Certain export duties, especially the duties on mustard oil and iron and steel levied by India as part of the post-devaluation measures affected India's exports to Pakistan. Pakistan, similarly, suspended its O.G.L. covering imports of Indian cotton textiles and raised the import duty on them to standard rates. The Pakistan import tariff was also revised in several cases to remove exemptions which had been hitherto granted to Indian manufactures. To these new hurdles to trade was added the difficulty of remittance through the banking system. As a result of these measures and counter-measures trade between the two countries dwindled and remained restricted to exchange of commodities on frontiers only.

It may be mentioned in passing that Pakistan's unfavourable balance of trade with countries other than India in 1948-49 was Rs. 6 crores. Its unfavourable balance of payments with these countries was Rs. 51 crores. Against this it had a favourable balance of trade with India of over Rs. 25 crores. The trade and payments gap was bound to increase continuously with countries other than India because of her no-devaluation decision which was also expected to cause complications about the partition debt. Under the inter-dominion financial agreement of 1947 Pakistan owed India about 300 crores of rupees. A sum of Rs. 100 crores was thus at stake in interpreting the term "rupees" in the agreement for Pakistan was certain to argue that the reference was to the Indian rupees and not to the assets equivalent to the corresponding Pakistani rupees. Moreover, there was the question of evaluating crores of rupees worth of evacuee property. If Pakistan succeeded in holding the present rate of exchange permanently, its burden of debt and liabilities to India would stand reduced by almost a third.

The matter continued to hang fire for a long time. Neither side showed the least inclination to yield and the I.M.F. looked on as a disinterested spectator presumably because while it fully sympathised with Pakistani aspirations, it was anxious to avoid hurting Indian feelings. Both Governments tried to prove the correctness of their respective decisions by publishing various trade and other statistics and emphasising the practical advantages which their countries had derived from their action. The Government of Pakistan stuck to its guns on the grounds that the higher exchange value of the Pakistan rupee (2s. 2d.) was quite in consonance with the country's interest and trade position and that it had helped the country to buy capital goods at cheap rates and had effectively checked inflationary tendencies in the country. Unfortunately it overlooked the fact that the jute growers of Pakistan were most adversely affected by her action and the foreign exchange reserves of the country were being speedily exhausted so much so that in

November 1950 Pakistan was a deficit country in its dollar and sterling accounts alike and the overall position looked gloomy judged from the numerous restrictions on imports and foreign exchange transactions which that country had had to impose. Fortunately for Pakistan there came the Korean War and the re-armament drive of the Western democracies which eased the country's foreign exchange position.

The Indo-Pakistan Trade Pact. The sudden turn in the international situation also provided a good opportunity in India to negotiate a fresh trade pact with Pakistan in February 1951. According to this agreement the par value of the Pakistan rupee was recognised. As was to be expected, the decision was acclaimed as a triumph of realism in some quarters and as a loss of faith in others. The critics doubted the wisdom of those who signed the pact after consistently repeating with determination not to yield on the question of the exchange rate. They asked many questions which revealed their distress and disappointment. Let us refer to some of these questions to see how far their fears were well founded. Why, it was asked, should the Government accept the rate at such a high level of Rs. 144 for 100 Pakistan rupees when the actual rate prevailing in the market varied between Rs. 112 and Rs. 122. Again when cotton and foodgrains were not available in adequate quantities what advantages, it was asked, would India derive by the pact which secured Pakistan all its terms without a corresponding benefit to this country. Further when the previous agreements with Pakistan had not met with any success, where was the guarantee that the new trade agreement would meet with better luck. And in the circumstances there seemed to be no justification for extending the period of the pact to so long as sixteen months. There were, of course, besides the emotional reactions of the people, the undesirable political implications involving the prestige of the Government of India also. In contrast to these reactions were those of the enlightened sections which were shrewd enough to visualise the many advantages that might accrue from the trade pact. Viewing the pact, purely from the practical businessman's point, they were not slow to welcome it as it was sure to help the revival of the trade between the two neighbouring countries. As regards the objection raised against the acceptance of a high rate of exchange, these critics argued in a convincing manner that the practical businessman was guided in his dealings with Pakistan by the price factor. It is only when he is able to dispose of the high priced Pakistani goods at a remunerative return, either in India or elsewhere in the world markets, that a trader bargains with Pakistan merchants for a deal. And dealings may be expected to be suspended the moment they cease to be profitable. This price principle applies equally to all commodities, whether it is cotton, raw jute, foodgrains or hides and skins. On the other hand satisfaction was expressed at the fact that the pact offers prospects of enabling the country to earn more foreign exchange as some of the dollar-earning industries such as jute and textiles, which faced acute raw material shartages, may be expected to find their needed

grist hereafter. As regards the term of 16 months covered by the agreement, it was pointed out that shorter term would not have inspired confidence among traders in both dominions. The trade pact was also welcomed in the hope that given a fair trial, it may increase Government revenues from custom duties and strengthen the hands of the Government in its international trade dealings.

Our own view in regard to this matter is that the decision, no matter how unpleasant from a purely sentimental point of view, was nevertheless justified by the altered economic circumstances. It may be remembered that our dispute with Pakistan all along had not been on the purely sentimental or the political plane, but merely on questions of economic fact. The main economic fact which brought about the dispute was that 70% of our imports from Pakistan consisted of raw jute and when Pakistan fixed both a high exchange rate and a high floor price for jute, we inferred that Pakistan was trying to extract a monopolistic advantage by virtue of its being the sole producer of raw jute, and accordingly we tried to exert on that country the only pressure open to us as consumers of its products by withholding our purchases from Pakistan. With an enormous increase in the price of jute in world markets it was no longer necessary to continue this resistance. Indeed, to have continued it any longer would have endangered our own economic interests without, in any way, furthering the cause of peaceful trade between the two neighbours.

A further justification for the new approach was also provided by the fact that, after devaluation, India's foreign exchange position had improved considerably and, from being a heavy deficit country before devaluation, India had since become a surplus country in its balance of payments. To be more precise, from a country with a deficit in its external accounts of about 200 crores of rupees in 1949 India closed the year 1950 with a surplus of over 80 crores and it did not have to take recourse to drawings on its sterling balances during that year. Thus, although exact figures are not available, India's accumulation of current sterling by the end of 1950 had been substantial and, therefore, she was no longer apprehensive of not having the requisite foreign exchange for financing the deficit in its trade with Pakistan. Hence, it must be admitted that our renewal of trade with Pakistan arose out of our strength in terms of foreign exchange and not out of weakness. It was further believed that the revival of Indo-Pakistan trade would also go a long way to strengthen India's foreign exchange reserves. With increased supplies of raw cotton and jute from Pakistan our capacity to earn foreign exchange was sure to increase. These exchange earnings were bound to help forward the process of economic development and also our ability to continue the maintenance of large food imports which have now become more or less a permanent feature of the country's economy.

The Recovery of the Pound. Great Britain, as we have seen, was forced to devalue the pound in view of its rapidly deterio-

rating economic situation. Almost a year after taking that action the tide had turned in her favour. Towards the end of 1950 people were buying sterling forward in large amounts with the result that a flood of overseas money, including dollars, had been pouring into London and the gold reserve had been increasing by more than the actual value of Sterling Area sales. Britain's gold and dollar holdings increased from $1,340 million in 1949 to $2,756 million at the end of 1950 while the monetary gold stock of the U. S. A. fell by $1,200 million in the same period. The improved new structure of exchange rates improved the competitive position of Great Britain and other Sterling Area countries in the dollar market and drove American goods out of the export markets. Thus Britain commanded additional resources which enabled her to make a substantial contribution to western re-armament. For this unprecedented recovery Great Britain was thankful to American assistance in the form of Marshall Aid. Among other factors which facilitated recovery may be mentioned the increase in the value of sales of raw materials from the British colonies in Africa and South East Asia, cut in dollar imports by the Sterling Area as a whole, and the additional earnings by the United Kingdom, particularly on the so-called invisible items like insurance and other commercial services and the sale of oil by sterling companies overseas. The strengthening of the position of Sterling against the dollar has led to the persistent rumours about the re-appreciation of sterling in terms of the dollar, in spite of the repeated denials of the British Government. Those who favour revaluation contend that revaluation of sterling would protect British consumers from the increase in domestic prices following from the rise in import costs and that it would help turn the terms of trade in favour of Great Britain. But the prominent economists of England are agreed that it would be very risky for the country to re-appreciate the pound in the midst of the very abnormal forces which are influencing the world exchanges at the present moment. A major war scare in Europe, a relapse in the Sterling Area commodity prices, or a break in the boom in the U. S. A., they fear, may reverse the prevailing trends and bring about a fall in sterling. Another strong reason against revaluation of sterling is that if there is any justification for re-appreciation of sterling there is equal justification for eliminating all restrictions on payments between sterling and the dollar. It would be evidently unreasonable to raise the value of sterling and yet to maintain discrimination against the dollar and against the U. S. A. in the operation of exchange control and import licensing. Hence, when the strengthening of the position of sterling reached such a magnitude as to justify a change in Britain's exchange policy, liberalisation of trade and free convertibility of sterling must precede any raising of the sterling in terms of the dollar. Among other arguments advanced against revaluation at least two more may be mentioned. The first is that revaluation would produce adverse effects upon the gold mining industry of South Africa and may compel it to leave the Sterling Area. The second is that revaluation would frustrate the efforts of those British industries which have found

some place in the dollar market or were attempting to do so.

The Revaluation of the Rupee. Ever since September 1950, when there were rumours about the revaluation of the pound sterling, and more particularly since the acceptance of the par value of the Pakistan rupee, talk of a revaluation of the rupee has been frequently in the air and both the protagonists and the antagonists of revaluation have argued out their respective cases fairly exhaustively. The controversy received additional support from the experience of Pakistan whose rupee since September 1950 has grown steadily firmer so that her present balance of payment position is strong enough for her to retain her parity with the dollar almost indefinitely. This is not merely because of large demands for her exports of raw cotton and jute. It is an improvement in the terms of trade which have greatly benefited the countries exporting raw materials. On the present indications, the terms of trade are continuing to move in favour of Australia, South-East Asia and Pakistan in a manner which implies that revaluation throughout this area would not do them any harm and may really increase their surpluses of trade.

In a recent issue of *Tata Quarterly*, Dr. John Mathai has tried to revive the controversy. It will be remembered that Dr. Mathai was the Finance Minister of India when the decision to devalue the rupee was taken. His advocacy of the opposite course of action now, therefore, deserves careful consideration.

Arguments in Favour of Revaluation. The exponents of revaluation maintain that devaluation was resorted to by India on account of the force of circumstances. Since those circumstances have now changed for the better a change of policy is clearly indicated. They also feel that the country is now faced with a huge purchase of foodgrains from outside. If to this the cost of other imports is added, India would be left with a big payments deficit which can be wiped out by appreciating the value of the rupee[1]. Some even go so far as to suggest that there will be a moderate improvement in the terms of trade and that the balance of payments will not deteriorate. In a special article contributed to the *Eastern Economist* in April 27, 1951 the author claims that there will be an adverse balance in 1951-52 of about Rs. 110 crores without revaluation and a favourable balance of about Rs. 10 crores after revaluation. Of course, this is opposed to the view expressed by the Finance Minister on the advice of the Reserve Bank that while, at present, we can hold things square, a full scale revaluation would give us an adverse balance of payments of Rs. 135 crores. The case for revaluation is also based on the fact that it is necessary to bring down the cost of living in India and that it cannot be done so long as Indian currency is under-valued. The *Eastern Economist* in its

1 Read "Revaluation and India's Balance of Trade", an article in the *Eastern Economist* of March 16, 1951 pp. 444.

issue of May 4, 1951 estimates a fall of about 7 to 10% in wholesale prices in the event of revaluation. The supporters of revaluation also believe that it is wrong to assume that with a revalued currency the country would not be able to maintain the present volume of exports. On the contrary, the broad factors of the world situation justify the belief that inflationary pressures will last a considerable period and maintain the present strength of the export market.

Arguments Against Revaluation. Those opposed to revaluation argue that world economic conditions are still so unsettled that no forecast can be made of future developments. In any case it is inadvisable to take unilateral action in adjusting the exchange value of the rupee. They, therefore, advise that we must wait until we know what other countries, with whom we are commercially and financially linked, are likely to do. Some oppose revaluation on the ground that it may result in a flood of imports and that it may lead to reduction in government revenues. These arguments do not seem to be very convincing because in the face of existing scarcity of industrial materials and capital goods in exporting countries the flood in imports need not be apprehended. As regards the loss of government revenue also it is doubtful if the apprehensions are well founded. As a matter of fact the *Eastern Economist* in a special article[1] entitled "Revaluation and the Central Budget" has expressed itself in the following words :—

> "In the event of a full scale revaluation, therefore, we break even in the final analysis. Our revenues which are now about Rs. 370 crores will shrink by Rs. 32·20 crores, but our revenue and capital expenditure together which is now Rs. 452·55 crores will shrink at the same time at least to Rs. 420 crores so that no net disequilibrium is involved."

Those who oppose the immediate revaluation of the rupee do not doubt that disinflation is the urgent need of the hour. They, however, maintain that revaluation cannot bring it about. Some of them have even suggested internal measures such as taxation, mopping up of savings, economy in public expenditure, price control etc., as more suitable remedies for inflation than revaluation. Moreover, the arguments for revaluation may have had some point in their favour in February 1951. They have very much less now, because the international price levels as well as the domestic price levels are moving downwards. The rise in the price levels and in the cost of living since devaluation, has been less in India than in some of the important countries as may be seen from the following table :

Percentage of changes in price level and cost of living between September 1949 and March 1951.

	U.S.A.	U.K.	Canada	Australia	India
Price Level	20	36	22	43	13
Cost of Living	9	7	11	20	9

1 April 20, 1951 Pp. 652-53.

Conclusion. As in most controversies much can be said on either side. But in order to come to a correct conclusion one must answer two questions, namely (*a*) is it necessary for India to revalue its rupee and if so, when, and (*b*) if revaluation is necessary, to what extent should the exchange rate of the rupee be put up ?

In answering the first question, one should remember that any change in the external value of the currency should be made only in the last resort and after all economic measures to rectify any imbalance in its payments position have been tried out. Considered from the point of view of foreign trade, India's position as it stands today does not seem to warrant the use of this weapon of last resort, namely the up-valuation of the rupee. This is evident from the published trade figures. The total value of trade in the year 1950 was Rs. 1036 crores as against Rs. 1070 crores in 1949. Of this, exports amounted to Rs. 541·44 crores and imports to Rs. 494·59 crores as against Rs. 441·61 crores and Rs. 628·82 crores respectively in 1949. These figures indicate that although the total volume of the foreign trade in 1950 has shrunk by Rs. 34 crores the fall is due solely to the reduction in imports to the extent of as much as Rs. 134 crores. During the same period, exports have gone up by as much as about Rs. 100 crores. This trend in the trade has enabled the country to achieve a favourable balance of trade to the extent of Rs. 46·85 crores as compared with an adverse balance of Rs. 187·5 crores in 1949. In our opinion it is neither prudent nor in the larger economic interests of the country to disturb this progress by letting into play a set of complimentary forces such as would result from revaluing the exchange rate. Besides, considerations of revaluation should not overlook the effects of such action on India's sterling balances. Today these balances are as high as Rs. 865 crores and they would naturally be reduced overnight to the extent the Indian rupee is up-valued. Moreover, if it was thought necessary to revalue the rupee we had certainly a better opportunity to do so before the Indo-Pakistan Trade Pact. Revaluation then would have secured for this country the advantages of cheap imports of foodgrains, raw materials, plant and machinery from other countries as well as from Pakistan. Now that an agreement has been reached on the basis of a high rate of exchange for the Pakistani rupee, any tinkering with the rate, in the absence of really strong reasons, might give room for protests from Pakistan and possibly lead to a break-down of the trade pact. This, in its turn, would mean the reappearance of the old deadlock with all its ugly repercussions. Surely, India has reasons not to court these. This is not to say that India has to forfeit all its right to take any decision it pleases in regard to the par value of its value. But prudence lies in waiting for the right time and, should conditions warrant it, taking a firm decision then pact or no pact. In the meanwhile, it is also possible that events abroad may so shape themselves as to call for a change in the value of the pound or the dollar. The loss of gold reserves in the U.S. arising from large-scale stock-pile imports and the steady accretions to gold and dollar reserves in the Sterling Area

point that way. In the circumstances, where is the hurry for the proposed unilateral action of revaluing the rupee now and thus closing all chances of fixing the exchange value in co-ordination with other countries and in more propitious circumstances ?

In regard to the second part of the question also, opinions differ very widely. Dr. Mathai has suggested the revaluation of the rupee to Rs. 12 to the pound or 1s. 8d. for the rupee. This suggests that the learned doctor is in favour of revaluation by stages. This is open to the objection that such revaluation would bring the currency under strong speculative pressures.[1] Lastly we should not forget the International Monetary Fund. Past experience shows that the Fund is not likely to approve of a change in our exchange rate, especially if it is to be above 10%. All said and done, there does not seem to be much fun in creating an uncertain set of circumstances which would benefit none but the speculators who are always keen to cash on such occasions.

The Government, according to the statements of the Finance Minister from time to time, appears to have given the matter utmost consideration and to have come to the conclusion that revaluation is not likely to be, *in the present circumstances*, in the interest of the country. "Anyone who is competent to examine the matter," says Sir Chintaman Deshmukh, in one of his statements, " has come to the conclusion that devaluation has been beneficial and that, till the outbreak of Korean hostilities, did not prove too difficult to check the increase in prices. If we were to revalue, we shall probably be worse off instead of being better off." Moreover his assurance that " we never remit the problem ; that is to say, this kind of problem will never be put on the shelf. But we can only take a decision from time to time," is exceedingly wise and encouraging and induces the hope that a correct decision will be taken at the right time.

1 Read "Revaluation by Degree", an article in the *Eastern Economist* of August 17, 1951.

CHAPTER XIV

HISTORY OF THE INDIAN PAPER CURRENCY SYSTEM

Before 1861. The paper notes are said to have existed in China in 800 A.D. and to have been adopted for use in Europe in the 17th century when the State Bank of Sweden issued them for the first time in 1656. They were practically unknown in India until the beginning of the nineteenth century when the foundation of the first Presidency Bank—the Bank of Bengal—was laid in 1806 to be followed by the Bank of Bombay in 1840 and the Bank of Madras in 1843.[1] Although these banks were purely private institutions, the Government liberally subscribed to their shares in lieu whereof they were allowed sufficient representation on their management. All the three of them enjoyed the privilege of note-issue but the maximum amount to which each could issue notes was fixed[2] (the limit in the case of the Bank of Bengal being Rs. 2 crores) and they had to keep 33⅓ per cent specie in reserve which was subsequently reduced to 25 per cent. These notes were not legal tender in any part of the country and quite frequently the Government refused to accept them. Their popularity was restricted to the presidency towns of Calcutta, Bombay and Madras, and the total amount of notes in circulation was very small compared to the size and population of the country. The denominations of the notes issued varied from bank to bank and "even the definition of a bank note was not universally agreed upon."[3]

1861-1914. After great hesitation the Government of India decided to establish their own monopoly of note-issue in 1861.[4] Act No. XIX of that year deprived the Presidency Banks of the right of issuing notes and created a Paper Currency Department through which the Government were to issue notes of various denominations in the form of promissory notes payable on demand. The country was divided into three circles of issue, *viz.*, Calcutta, Madras and Bombay, and notes issued from any of these circles were not legally

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1 Between 1770 and 1864 there were about 35 banks, 10 of which, including the three Presidency Banks, were allowed to issue notes. The issue of some are said to have been very satisfactory. B. B. Dass Gupta—*Paper Currency in India*—Pp. 5-6.

2 This did not hamper the growth of note circulation as some people have imagined because whereas the Presidency Banks were allowed *together* to issue notes up to Rs. 5 crores they had seldom issued more than Rs. 2 crores. The non-Presidency Banks were even free from these restrictions.

3 Dass Gupta—*Paper Currency in India*—p. 8.

4 This may have been due partly to the desire of the Government to improve the state of Paper Currency and partly to a more selfish motive of making profit on note-issue.

encashable outside their respective areas. Later, as paper currency increased in circulation, more circles were created. The new system was modelled on the fixed Fiduciary or the Currency Principle.[1] Notes up to the value of Rs. 4 crores were to be backed by securities and the *whole amount above it* had to be secured against an equivalent amount of silver coin and bullion in the reserves. This arrangement secured *complete freedom from over-issue* but only *at the expense of elasticity* which was particularly desirable on account of the increased demand for currency in the busy season and the comparative absence of banking facilities. "Government gained nothing by the issue of notes as the currency officer had to keep in reserve an equivalent amount in coin or bullion, and so notes were *no longer economical* than rupees."[2] The rigidity, that is, inability to expand and contract, was somewhat relaxed partly by the closing of the mints in 1893 when the rupee, having become a token coin, less silver was required to be kept in reserves than previously[3] and partly by raising the limit of the fiduciary portion from Rs. 4 crores in 1861 to Rs. 14 crores in 1913. In 1898 a portion of the Paper Currency Reserve, which was originally intended to ensure the encashment of notes, was transferred to England (and kept in gold) for the purchase of silver required for minting rupees. Thus it became a part of complicated mechanism of the gold exchange standard[4] and was freely drawn upon for the purpose of maintaining the external value of the rupee (through the sale of Council and Reverse Council Bills). In addition to strengthening the gold (or London) portion of the Reserve, the Government endeavoured to universalise notes of smaller denominations with a view to increasing their popularity.

The Chamberlain Commission. The Chamberlain Commission (1913) desired to introduce a further measure of elasticity in the organisation of paper currency. Therefore they recommended that the fiduciary portion of the reserve should be increased from Rs. 14 crores to Rs. 20 crores and should thereafter be fixed at a maximum of the amount of notes held by the Government in the Reserve Treasuries plus one-third of the net circulation.[5] The Government should also take power to make temporary investment or loans from the fiduciary portion within this maximum in India and in London as an alternative to investment in permanent securities. In India the loans should be made to the Presidency Banks and in London the Secretary of State should have the power to lend out sums received in payment of Council Drafts sold against the currency reserve in the busy season provided that the total cash portion of the Paper Currency Reserve does not fall below two-thirds of the net circulation.

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1 See pp. 6

2 Chablani—*Indian Currency, Banking and Exchange*—p. 21.

3 A ten-rupee note, for example, could be issued by keeping in reserve silver worth Rs. 6 only.

4 See Chapter X.

5 Meaning gross circulation minus notes held in Reserve Treasuries.

They also recommended that the use of notes should be encouraged by all legitimate means. The number of places at which notes were encashable as of right as well as the extra facilities for encashment should be increased and the Rs. 500 notes should be universalised.

The Commission expected many advantages from these recommendations. In the first instance, it would be possible for the Government to lend temporarily from the Paper Currency Reserve especially during the busy season when a permanent investment would be unwise. The Government would earn considerable interest on sums which would otherwise remain idle while the money market would, by this temporary expansion of currency in the busy season, obtain some relief from the seasonal currency. Secondly, the Government would be able, as the note circulation increases, to add to the permanent or temporary investment of the Reserve without special legislation. Thirdly, the power to make temporary investments in London on account of the Paper Currency Reserve would be a convenience to the Secretary of State in permitting him to sell Council Drafts against the Paper Currency Reserve in anticipation of silver purchases or any other cause without the loss of interest and other disadvantages which might sometimes come about if he was compelled, without discretionary power, to use the entire proceeds of such sales in earmarking gold. Fourthly, the note-issue will not only be more elastic, but it would also be more popular.

This Report, however, was still bcrn. Its recommendations were yet under the consideration of the Government when the War broke out and further consideration was postponed until the return of normal conditions.

1914-19. The War Period. During the first year of the War the paper currency system was subjected to a heavy strain. Notes were presented in large amounts for being converted into gold which at first the Government allowed but after losing about £1,800,000 between the 1st and 4th August of 1914 the Government refused to issue any more gold to the public. Confidence, however, was quickly restored. From 1915 onwards the demand for Indian currency, (especially Paper Currency) increased considerably.[1] Owing to the scarcity of precious metals, there was no alternative but to issue notes against securities. The fiduciary portion, therefore, was increased from Rs. 20 crores to Rs. 120 crores on the strength of which in addition to the notes of existing denominations new notes of Rs. 2½ and Re. 1 were put into circulation. The public, at first, hesitated to accept the new notes which in the beginning circulated at a discount[2] but so great was the demand for currency that they

1 Owing to a highly favourable balance of trade and scarcity of metallic currency. Also see Chapter XI.

2 "Discount as high as 15 per cent and 19 per cent has been reported ; but the discount rapidly diminished when it was seen that the notes were freely accepted in payment of Government dues and when small coins were made available in large quantities. Gupta—*Paper Currency in India*—p. 109. Also read the *Report of the Commission on Indian Exchange and Currency* (1919), *para* 29.

also got absorbed into circulation. The demand for additional currency was met by the purchase of 200 million ounces of silver from America.

It has been pointed out that the number of securities in the reserve had to be increased to finance the growing trade of India. Owing to the increase in the rate of interest the market value of these securities declined enormously. "With a view to replacing them gradually by more suitable securities it was decided to create a Paper Currency Reserve Depreciation Fund out of the interest received on paper currency investment."[1]

Babington Smith Committee (1919). On the termination of War, the Indian Currency System was carefully examined by the Babington Smith Committee in 1919. The Committee were anxious to see that the note-issue was fairly elastic and at the same time, backed by sufficient amount of metal in the reserve. Consequently they recommended :—

(1) That the legal minimum for the metallic portion of the reserve should be 40 per cent of the gross circulation and that the gold in the Paper Currency Reserve should be revalued at 2s. to a rupee (instead of 1s. 4d. as before the War) ;

(2) that the limit of the fiduciary portion should, for some time, continue to be Rs. 120 crores of which not more than Rs. 20 crores be securities of the Government of India ;

(3) that provision should be made for the issue of additional currency in the busy season up to Rs. 5 crores, over and above the normal fiduciary issue, as loans to the Presidency Banks on the security of export bills of exchange ;

(4) that silver and gold in Paper Currency Reserve should be held in India except for purchasing silver in London ; and

(5) that as soon as circumstances permit, free facilities for the encashment of notes should be given and the restriction imposed during War should be withdrawn. The Government should have the option of redeeming their notes in full legal tender gold or silver coin.

Acts of 1920 and 1923. It will be noticed that the Smith Committee made very bold suggestions for increasing the elasticity of Paper Currency. Forty per cent limit of the metallic portion was *much too low* considering that the masses were illiterate and more accustomed to metallic coins than paper money. The number of securities allowed to be put in reserves was *abnormally high* and, on top of this, there seemed to be hardly any justification for issuing additional currency in the busy season. The government realised the force of these arguments and modified the recommendations of the committee which were embodied in the Paper Currency Act of 1920 and

1 Chablani—*Studies in Indian Currency, Banking and Exchange*—Pp. 27-28.

the Consolidating Act (No. VI) of 1923. The provisions of the latter Act fall under two classes—permanent and transitory.[1]

(*a*) *Permanent Provisions.*

(1) The metallic reserve was to be at least 50 per cent of the total reserve. The reasons for accepting a higher percentage than that suggested by the Smith Committee, which was only 40 per cent, were the necessity of encashing the notes without question in a country like India and the necessity of holding sufficient coins in the reserve to finance the movement of goods during the busy season when notes are generally presented for encashment on a very large scale.

(2) With the exception of Rs. 20 crores worth of securities held in India the remainder were to be held in England and should be short term securities not exceeding a period of twelve months as suggested by the Smith Committee.

(3) The Controller of Currency was authorised to issue notes up to an amount of Rs. 5 crores against discounted bills of exchange maturing within 90 days of their issue. This extra issue should take the form of loans to the Imperial Bank which should pay 8 per cent interest to the Government and deposit accepted bills of exchange with the latter.

(4) The Secretary of State was not to hold more than five million pounds in gold bullion in London.

(*b*) *Transitory Provisions.*

Owing to the difficulty caused by the necessity of revaluing the gold and sterling securities of the reserve on the basis of Rs. 10 to the sovereign, instead of Rs.15, certain transitory provisions became necessary pending the final attainment of the permanent provisions. With the revaluation on the 10-rupee basis the metallic portion of reserve would have been less than 50 per cent. It was, therefore, provided that the invested portion might, for the time being, be fixed at Rs. 85 crores and that the Government of India be authorised to create rupee securities on their own hand (*'ad hoc' 'created'* securities) and to issue them to the Paper Currency Reserve.

It will be seen that the only change of importance was in the minimum percentage of the metallic portion of the reserve which was fixed at 50 per cent instead of 40 per cent as recommended by the Smith Committee.[2]

1923-26. On the establishment of the Imperial Bank in 1921 the power of issuing seasonal currency against inland bills of exchange was entrusted to it and the limit was raised from Rs. 5 crores to Rs.

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1 Prof. Jevons in his *Money Exchange and Banking in India* (1927) had hoped that the permanent provision could be realised in five or six years' time. Later events, however, belied his expectations.

2 But as the power to issue Rs. 25 crores of notes against commercial bills of exchange was authorised, the real limit was virtually reduced to 47½ per cent.

12 crores in 1923-24.[1] In 1925, the permissible size of security holding, *viz.*, Rs. 85 crores, was felt to be too small and was increased to Rs. 100 crores provided that the value of created securities did not exceed Rs. 50 crores.[2] Two-and-a-half-rupee and one-rupee notes which were issued during the period were cancelled in January 1926.

The Hilton Young Commission (1926). The system again came under the searching examination of the Hilton Young Commission in 1926. The Commission recommended that the sole right of note-issue should be transferred to the Reserve Bank and the Government notes should cease to be legal tender except at Government Treasuries. The notes of the Bank were to be full legal tender and were to be guaranteed by the Government. The legal obligation to convert paper currency into silver coin was to be withdrawn although facilities were to be given for the free inter-changeability of different forms of legal tender currency and for their ultimate conversion into *gold bars*[3] of not less than 400 ounces at specified rates. The Paper Currency and Gold Standard reserves were to be amalgamated and the proportion and combination of the combined Reserve were to be fixed by statute. The new system was to be based on the Proportional Reserve Principle and the proportion of silver in the reserve was to be substantially[4] reduced during the next ten years.

Act of 1927. Most of these recommendations were incorporated in Act No. VI of 1927 according to which the gold value of the rupee was fixed at 8·475 grains per rupee (instead of 11·00316 grains as previously). The Government undertook to buy gold in bars of not less than 40 tolas at Rs. 21-3-10 per tola and to sell gold *or Sterling at the option of the Government,* at the same price after allowing for the cost of transportation from Bombay to London, in amounts of not less than 1,065 tolas. The Bill authorising the creation of the Reserve Bank was rejected by the Legislative Assembly in 1927.

1927-31. The Act of 1927 committed the Government to the Gold Bullion Standard *only so long as the sterling was linked to gold.* But in September, 1931, when England abandoned the gold standard[5], the paper currency came virtually to be linked to sterling.

The Reserve Bank Note Issue. With the passing of the Reserve Bank of India Act of 1934, the sole right of note-issue also passed into the hands of the Reserve Bank, although provision had been made

1. Owing to continued monetary stringency.
2. Note that, since 1918, a large portion of the Indian invested reserve has consisted of "created" securities, that is to say, treasury bills *issued by Government to itself.* Currency notes were issued by Government against its own I. O. U.s and watering down of the currency meant a floating public debt without obligation to pay interest thereon. Kale—*Indian Economics*—p. 530.
3. See Chapter XII.
4. From Rs. 85 crores to Rs. 25 crores.
5. See Chapter XII.

for the use of Government of India Currency notes during the initial period.[1]

Issue Department. The issue of bank notes shall be conducted by the Bank in an Issue Department which shall be separated and kept wholly distinct from the Banking Department.

Denominations of Notes. Bank notes shall be of the denominational value of five rupees, ten rupees, fifty rupees, one hundred rupees, five hundred rupees, one thousand rupees and ten thousand rupees.

Legal Tender Character of Notes. Every bank note shall be legal tender at any place in British India and shall be guaranteed by the Governor-General-in-Council.

Bank Exempt from Stamp Duty on Bank Notes. The Bank shall not be liable to the payment of any stamp duty under the Indian Stamp Act, 1899, in respect of bank notes issued by it.

Assets of the Issue Department. The assets of the Issue Department shall consist of gold coin, gold bullion, sterling securities, rupee coin and rupee securities to such aggregate amount as is not less than the total of the liabilities of the Issue Department. Of the total amount of the assets, not less than two-fifths shall consist of gold coin, gold bullion, or sterling securities[2] provided that the amount of gold coin and gold bullion shall not, at any time, be less than forty crores of rupees in value. The remainder of the assets shall be held in rupee coin, Government of India rupee securities, and such bills of exchange and promissory notes payable in British India which are eligible for purchase by the Bank, provided again that the amount held in Government of India rupee securities shall not, at any time, exceed one-fourth of the total amount of the assets or fifty crores of rupees, whichever amount is greater or, with the previous sanction of the Governor-General-in-Council, such amounts plus a sum of ten crores of rupees.[3] Gold coins and gold bullion in the reserve shall be valued at 8·47516 grains of fine gold per rupee—rupee coin shall be valued at its face value and securities shall be valued at the current market rate. Of the gold coin and gold bullion held as assets, not less than seventeen-twentieths shall be held in British India and all gold coin and gold bullion held as assets shall be held

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1 Under the India and Burma (Monetary Arrangements) Order, 1937, the Reserve Bank has also the exclusive right of note-issue in Burma.

2 The sterling securities which may be held as part of the assets shall be securities of any of the following kinds payable in the currency of the United Kingdom, namely :—

(*a*) Balance at the credit of the Issue Department with the Bank of England ;

(*b*) Bills of exchange bearing two or more good signatures and drawn on and payable at any place in the United Kingdom and having a maturity not exceeding ninety days.

(*c*) Government securities of the United Kingdom maturing within five years.

3 Note that this clause has been repealed by an Ordinance dated 8th February, 1941 and that there is now no limit to the holding of rupee securities by the Reserve Bank.

in the custody of the Bank or its agencies. In exceptional circumstances, the Bank may, with the previous sanction of the Governor-General-in-Council, for periods not exceeding thirty days in the first instance, which may, with the like sanction be extended from time to time by periods not exceeding fifteen days, hold as assets gold coin, gold bullion or sterling securities of less aggregate amount provided that the gold coin and gold bullion shall not, at any time be reduced to less than two-fifths of the total assets. During such period the Bank shall pay to the Governor-General-in-Council a tax upon the amount by which such holding is reduced, at the current bank rate with an addition of one per cent per annum when such holding exceeds thirty-two and a half per cent of the total amount of the assets.

Liabilities of the Issue Department. The liabilities of the Issue Department shall be an amount equal to the total of the amount of currency notes of the Government of India and the bank notes for the time being in circulation.

Reserve Bank of India notes were first issued to the public in India in January 1938, when supplies of five-rupee notes became available. Ten-rupee notes were issued in the following month while Rs. 100 and Rs. 1,000 notes were issued in May, 1938. The Bank does not propose to issue Rs. 50 or Rs. 500 notes but Government of India notes of these and other denominations continue to be full legal tender.[1]

The Paper Currency Reserve—Its Location and Composition. It has been seen that the Paper Currency Reserve was instituted in 1861 to ensure the encashment of notes in rupees. It was, therefore, for several years, kept in silver and in India. But in 1898 this policy was, for the first time, departed from and a portion of the Reserve was located in London to be used for the *purchase of silver* required for rupee coinage and also for the *support of exchange.* In 1898 an Act was passed enabling notes to be issued against gold held by the Secretary of State in London. Thereafter, whenever the Secretary of State sold Council Bills in excess of his own requirements (in respect of Home Charges) they were paid out of the Reserve in India, and the Secretary of State transferred an equivalent amount of gold to the account of the Reserve in London. Thus the Secretary of State used to either (1) hold gold in England as part of the Reserve against the note-issues in India, or (2) transmit the gold to this country to serve the same purpose here, or (3) expend it on the purchase of silver also to form part of the Reserve. It is, therefore, evident that the Reserve, up to April, 1935, used to perform a variety of functions. Apart from being used for the conversion of notes, it was regarded as the "first line of defence" in a time of exchange crisis. No wonder, therefore, that its composition and location have depended, from time to time, upon the exigencies of the international trade as the following tables will show.

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1 Reserve Bank of India—*Report on Currency and Finance for the year* 1937-38.

COMPOSITION OF THE PAPER CURRENCY RESERVE

(A)

(In crores of rupees)

Year	Gross Note Circulation	GOLD		SILVER		SECURITIES		
		In India	Out of India	Coin	Bullion	Indian	British Treasury Bills	Others
1914	66·1	22·4	9·1	20·5	...	10·0	...	4·0
1915	61·6	7·6	7·6	32·3	...	10·0	...	4·0
1916	67·7	12·2	11·9	23·0	·5	10·0	·0	4·0
1917	86·3	12·0	6·6	17·0	2·1	10·0	84·4	4·3
1918	99·7	26·8	·6	10·4	·3	10·0	48·1	3·3
1919	153·4	17·3	·7	16·6	20·7	16·9	81·2	1·2
1920	174·5	44·3	8·4	33·2	6·6	19·5	67·2	...
1921	166·1	21·1	...	61·4	4·1	66·0	8·3	...
1922	174·7	24·3	...	72·9	4·5	67·0	5·3	...
1923	174·7	24·3	...	82·5	4·5	57·4	5·8	...
1924	185·8	22·3	...	74·1	5·8	69·5	14·0	...
1925	184·1	22·3	...	70·0	6·7	65·4	20·0	...

(B)

(In crores of rupees)

Year	Gross Note Circulation	SILVER		Gold Coin and Bullion in India.	Sterling Securities in England.	Rupee Securities in India.	Internal Bills of Exchange.
		Coin	Bullion				
1926	193·3	77·2	7·6	22·3	29·0	57·1	...
1927	184·1	95·9	8·5	22·3	5·5	49·7	2·0
1928	184·8	98·7	7·6	29·7	3·7	37·9	7·0
1929	188·0	94·9	4·9	32·2	10·6	43·2	2·0
1930	177·2	108·1	2·8	32·2	15·0	33·8	...
1931	160·8	117·8	6·9	25·8	...	10·2	...
1932	178·1	191·9	9·2	5·3	...	57·9	3·7
1933	176·9	96·3	15·2	25·9	...	39·1	...
1934	177·2	86·5	11·5	41·5	8·2	29·4	...
1935	186·1	79·2	13·1	41·5	18·2	35·9	...

The Act of 1911 fixed the limit of fiduciary issues at Rs. 14 crores of which not more than 4 crores may be in sterling securities invested in London. By the Act of 1919 this limit was raised to Rs. 120 crores. In the beginning the gold of the Paper Currency Reserve in London used to be kept earmarked with the Bank of England to safeguard the note-issue of the Government of India and was not available to the London money market but the law was soon amended and the Secretary of State was not only empowered to handle the gold of the Paper Currency Reserve without restraint but also to convert most of this gold in to sterling securities.

Since the balance of trade was generally favourable to India large funds were kept locked up in England to the detriment of the country. The public objected to the employment of the Reserve for purposes other than those for which it had been created and to the purchase of silver in London. India has a large bullion market and it is capable of great expansion. If the Government purchases silver in this country, the bullion dealers will be greatly benefited without causing any loss or inconvenience to the Government. Morever, it was unfair to lock up these reserves in England or to use them for the benefit of London money market, especially at a time when the Indian market was literally starving for currency. It is of particular importance, therefore, to remember that, with the establishment of the Reserve Bank in April, 1935, the Gold Standard Reserve and the Paper Currency Reserve were amalgamated and the entire stocks of gold were transferred to the Bank. The position of the combined reserve as revealed in the balance-sheet of the Issue Department was as follows :—

RESERVE BANK OF INDIA

ISSUE DEPARTMENT

An account pursuant to the Reserve Bank of India, Act, 1934, for the week ending on the 5th day of April, 1935.

Liabilities	Rs.	*Assets*	Rs.
Notes held in the Banking Department	19,05,29,000	A. Gold Coin and Bullion—	
Notes in circulation ...	1,66,99,97,000	(a) Held in India ...	41,55,19,000
		(b) Held outside India	2,86,98,000
		Sterling Securities ...	48,62,95,000
Total Notes Issued ...	1,86,05,26,000	Total A ...	93,05,12,000
		B. Rupee Coin ...	49,94,95,000
		Government of India Rupee Securities ...	43,05,19,000
		Internal Bills of Exchange and other commercial papers	...
Total Liabilities ...	1,86,05,26,000	Total Assets ...	1,86,05,26,000

The liabilities show very little change amounting to Rs. 186·5 crores as against Rs. 186·10 crores of the Currency Department of Government on the last day of 1934-35. On the assets side gold coin and bullion is shown at Rs. 444·2 crores valued at the statutory parity, made up of the gold holdings of the Government of India of the value of Rs. 41·45 crores in the Paper Currency Reserve and Rs. 2·87 crores in the Gold Standard Reserve. Sterling and rupee securities increased respectively from Rs. 18·28 crores to Rs. 48·63 crores and from Rs. 35·90 crores to Rs. 43·05 crores. Rupee coin declined from Rs. 77·25 crores, to Rs. 49·95 crores, silver coin and bullion in excess of Rs. 50 crores being no longer held as part of assets. The gold coin and bullion combined with the sterling securities stood at Rs. 93·5 crores and together amounted to Rs. 50·01 per cent of the total liabilities. The following table will give an idea of the subsequent liabilities and assets of the Issue Department of the Reserve Bank of India at the end of each financial year. It will be noticed that during the four years preceding the second World War the circulation of notes had increased from Rs. 164 crores to a little over Rs. 230 crores. This excess issue had been largely secured against rupee coin and rupee securities with the result that the proportion of gold and sterling securities had fallen from Rs. 55·5 in 1935-36 to Rs. 53·9 in 1939-40.

Reserve Bank of India : Issue Department since 1935-36

[In lakhs of Rupees]

Year	LIABILITIES		Total Liabilities (Total Notes Issued)	ASSETS				4+5 as %3
	Notes in circulation	Notes held in the Banking Department		Gold coin and Bullion	Foreign Securities	rupee coin	Rupee Securities	
	1	2	3	4	5	6	7	8
1935-36	164,06	27,58	191,64	44,42	62,09	55,51	29,62	55,58
1939-40	220,31	18,87	238,18	44,42	78,63	67,52	37,44	53,97
1940-41	254,79	17,46	272,25	44,42	129,92	35,87	48,46	65,39
1941-42	329,88	12,44	340,32	44,42	165,00	35,28	75,19	65,47
1945-46	1,162,64	16,41	1,179,05	44,42	1,061,26	15,53	57,84	93,78
1946-47	1,222,96	32,61	1,255,57	44,42	1,133,88	19,43	57,84	93,85
1947-48	1,227,82	47,12	1,274,95	44,42	1,135,32	32,36	62,84	92,53
1948-49	1,236,95	22,02	1,258,97	42,49	907,47	43,86	265,62	75,43
1949-50	1,128,94	24,00	1,152,94	40,02	647,04	50,53	415,36	59,59

Paper Currency since September 3, 1939. We have seen in the preceding chapter that during the War the circulatio n of notes increased by more than Rs. 942 crores.

The balance sheet of the Reserve Bank for the year 1945-46, also contained some interesting facts. The value of total notes issued, which constituted the sole liability of the Bank in its Issue Department, was Rs. 1,179 crores. Of this amount notes to the value of Rs. 16·4 crores were held in the Banking Department of the Bank while notes to the value of Rs. 1,162 crores were in circulation. The assets against this liability were Rs. 44·42 crores in gold coin and bullion, Rs. 1,061 crores in sterling securities, Rs. 15·5 crores in rupee coin and the balance of Rs. 57·8 crores in Government of India rupee securities. It will also be worthwhile to remember in this connection that the Reserve Bank of India Act allowed only a fourth of the assets to be held in rupee securities. The percentage of rupee securities in the reserve when the War began stood at Rs. 17·6 but increased to Rs. 22·7 within two years. It was obvious that it would soon exceed the statutory limit of 25 per cent. Hence, the operation of the Act was suspended by an Ordinance issued on 8th February, 1941 and the percentage of rupee securities reached Rs. 26·5 in 1942-43. Therefore, it showed a marked decline and in 1945-46 when the War was over it had fallen to less than 5 per cent.

The assets of the Issue Department, according to the Reserve Bank Act, should consist of gold coin, gold bullion, sterling securities, rupee coin and rupee securities to such aggregate amount as is not less than the total liabilities of the Issue Department. Of the total amount of assets not less than two-fifths should consist of gold coin, gold bullion or sterling securities provided that the amount of gold coin and gold bullion is not at any time less than Rs. 40 crores in value. It will be noticed that the value of the gold holdings of the Bank in its Issue Department was more than Rs. 4·42 crores above this statutory limit. The gold coin and bullion were valued at 8·47512 grains of fine gold per rupee but at the current market prices the value of the gold holdings was more than Rs. 88 crores.

But a rather distressing feature of the reserve was the high percentage of sterling securities. The sterling portion of the reserve increased from about 32·5 per cent in 1939-40 to about 60 per cent in 1942-43 and 90 per cent in 1945-46. Even in a period of normal political and economic life this would have been undesirable and it was many times more so when a major war was going on. It is doubtful wisdom for the central bank of any country to invest such a large part of its paper currency assets in securities of a belligerent country. The sterling assets in the Banking Department of the Reserve Bank had no doubt helped the Government in repatriating some sterling loans but here again it may be asked whether the purpose behind this repatriation move was to make sterling available in England for reinvestment in war bonds. In any case, the sterling assets of the Reserve Bank seemed to have exceeded what it would be necessary,

desirable and prudent to have."[1] That the position greatly worsened after the War can be seen from the fact that the percentage of the reserve backed by foreign securities was over 99 in 1946-47. In other words, the amount of foreign securities in the reserve increased from Rs. 78·6 crores to over Rs. 1133·8 crores, an increase of more than 1300 per cent. This gave rise to another and a rather serious problem, namely, that of the repatriation of sterling securities to which we have already referred. The proportion of foreign sterling securities in the reserve should be regulated by statutory provision and should not be allowed to exceed, say 30 per cent. Such a provision would not only be in conformity with modern practice in most countries, but would also act as a wholesome check to inflation."[2]

But all said and done there was, during the War period, behind each currency note, its full value in gold, easily realisable sterling, silver rupees or obligations of the Government of India which are realisable at a moment's notice. There were ample stocks of silver rupees at currency offices, treasuries and branches of the Imperial Bank and currency notes could be freely exchanged into rupees.

The proportion of gold and sterling securities in the reserve which had reached 93·85 per cent of the total notes issued in 1946-47 began to decline after the War and had fallen to 59·6 in 1950. The percentage of sterling securities also fell from 99 to 56 in the same period. On the other hand, the amount of rupee securities, which was less than 5 per cent when the War terminated, increased to 21 per cent in 1948-49 and stood at 36 per cent of the total liabilities of the Issue Department in 1950. The percentage of rupee coin having declined from about 28 in 1939-40 fell to 1·2 in 1945-46 but increased to 3·3 in 1948-49 and 4·3 in 1949-50. These tendencies have been maintained in recent years.

SUMMARY

Before 1861. The notes in India were issued for the first time by the Presidency Banks in the nineteenth century. The maximum amount up to which each bank could issue notes was fixed and they had to keep 33 per cent specie in reserve. The notes were legal tender in a limited area and their popularity was greatly restricted.

1861-1914. In 1861 the Government undertook to issue notes themselves through the newly created Paper Currency Department. Notes of the value of Rs. 4 crores were to be backed by securities and the whole amount above it had to be covered by an equivalent amount of gold or silver (Fixed Fiduciary Principle). This system guaranteed freedom from over-issue but only at the cost of elasticity. The rigidity was gradually reduced in 1893 when the rupee became a token coin and by raising the limit of the fiduciary portion from Rs. 4 crores to Rs. 14 crores. In 1898 a part of the Paper Currency Reserve was transferred to England for the purchase of silver and thus became a part of the gold exchange system. In order to make paper currency still more elastic the Chamberlain Commission recommended that the limit of the fiduciary portion may be increased to Rs. 20 crores and that temporary loans may be given out of the reserve both in India and in England. No action was taken on the Report due to war.

1 *The War and the Rupee,* an article by Prof. B. Datta in the *Modern Review.*

2 L. C. Jain—*Indian Economy during the War,* p. 77.

1914-1919. During the first year of the War, notes were presented for conversion into gold but later on the demand increased so enormously that the fiduciary portion had to be increased to Rs. 120 crores and fresh notes of Rs. 2½ and Re. 1 had to be put into circulation with practically no metallic cover.

Babington Smith Committee. They recommended that the legal minimum for the metallic portion should be 40 per cent of the gross circulation and that the maximum limit of the security portion should be Rs. 120 crores. They also suggested the issue of additional currency in the busy season against export bills of exchange. By recommending a rather low limit of the metallic portion and by allowing too many securities in the reserve the Committee made the system dangerously elastic. The Government accepted their recommendations with the only difference that the amount of the metallic portion was fixed at 50 per cent instead of 40 per cent. On the establishment of the Imperial Bank the power of issuing emergency currency was entrusted to it and the amount was raised from Rs. 5 crores to Rs. 12 crores.

The Hilton Young Commission. They recommended that the right of note-issue should be entrusted to the Reserve Bank. The new notes were not to be legally convertible into gold bars of not less than 400 ounces at specified rates. The Gold Standard and the Paper Currency reserves were to be amalgamated and the composition of the combined Reserve fixed by law. Owing to the rejection of the Reserve Bank Bill, the Government could not give effect to these recommendations. By the Act of 1927 the Government undertook to purchase gold from the public in amounts of not less than 40 tolas and to sell gold to the public in amounts of not less than 1,055 tolas at rates calculated on the 18d basis of the rupee but even this arrangement fell through in 1931 when England abandoned the gold standard and our currency, including paper notes, came to be linked to sterling.

The Reserve Bank Note-issue. With the passing of the Reserve Bank Act of 1934, the paper currency system has entered a new phase. The power of issuing notes has been transferred to the Reserve Bank and is exercised through the Issue Department which is quite distinct from the Banking Department. Of the assets of the Issue Department, not less than 2/5ths shall consist of gold or sterling securities provided that the amount of the metallic portion shall not, at any time, be less than forty crores of rupees, and the rest shall be held in rupees, Government of India securities, bills of exchange and promissory notes which the Reserve Bank is allowed to deal in. Of the metallic portion at least 17/22ths shall be kept in British India.

The Paper Currency Reserve. It was originally created to ensure encashment of notes but it has gradually become a very important part of the machinery of the gold exchange standard. It was freely drawn upon for the purchase of silver and for selling Council Bills etc. The public has always resented this misuse of reserve and feels greatly relieved now that the Gold Standard Reserve and the Paper Currency Reserve have been amalgamated and the combined reserve is maintained in India.

Paper Currency since September 3, 1939. The War did not affect our paper currency system too badly. Additional notes of the value of about Rs. 945 crores were issued. This increase was secured by increasing the amount of rupee securities by Rs. 20 crores and by increasing the proportion of gold coin and bullion and sterling securities by 30 per cent. By 1946-47, the amount of sterling securities in the reserve had increased by more than 1300 per cent. The presence of such a large amount of foreign securities was not wise. The Bank should have arranged for more gold and should have prevented the decrease in rupee coins.

The percentage of sterling securities fell and the amount of rupee coin and rupee securities increased after the war.

QUESTIONS

1. Give a short history of the Indian Paper Currency System from 1861 to 1914. [Delhi Inter. 1929 and 1934]

2. What do you mean by "elasticity" ? Examine the recommendations of the Chamberlain Commission and the Babington Smith Committee to remedy the inelasticity of the Indian Paper Currency System. [Delhi Inter. 1928]

3. What is the proper function of the Paper Currency Reserve ? How is the Reserve actually used ? Explain why its composition and location are changed from time to time. [Delhi Inter. 1931]

4. What is the connection between the Gold Standard Reserve and the Paper Currency Reserve ? Are you in favour of keeping them separate ? Give reasons. [Punjab B. A. 1932]

5. Point out the salient features of the Indian Paper Currency System as it exists at present. [Delhi B. A. 1931]

CHAPTER XV

BANKS AND BANKING

Definition of a Bank.[1] The trade of banking has been exercised from very early times. The nature of business transacted by the banks has varied so widely from age to age and from country to country that it is impossible to define a bank. The art of banking originated with the goldsmiths who did no more than change one currency for another and enabled merchants to obtain good currency at a time when a great variety of debased coinage was in existence. Even today the indigenous money-lenders are called bankers although they do not perform any of the recognised functions of modern banks, namely, receiving of deposits, dealing in bills of exchange, or issue of notes etc. Walter Leaf[2] has defined a bank as "a person or corporation which holds itself out to receive from the public, deposits payable on demand by cheque." This, as he has himself admitted, holds good for Great Britain and perhaps United States but not for the Continent where the use of cheque is too little developed to be regarded in any sense as a fundamental part of the functions of a bank. Conant describes the banker as "a trustee of the money of the depositors" and as "the trustee of the mechanism of credit for the entire community." Horace White, in his *Money and Banking*, has defined a bank "as a manufacturer of credit and a machine for facilitating exchanges."[3] According to Scott "the customers of a commercial bank sell to it their surplus cash and credit instruments representing payments due to them from other persons and make loans from it secured by their personal notes due to them as a result of their transactions. They are credited on the books of the bank in a form known as deposits. The making of loans and discounts is a function correlative with that of conducting deposit accounts. It may be described as a process of advancing funds on the "security of personal notes." Referring to the several ingenious definitions of "Banks" put before them, the Central Banking Committee stated, "Fairly exhaustive and helpful as these suggestions are, we find that the task of defining the term 'Bank' or 'Banker', which has been regarded as well-nigh impossible in other countries, is much more so in India where the definition cannot be drawn up without excluding many firms of indigenous bankers and individuals who do a considerable portion of the finan-

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1 The word "banck" was a German term signifying a joint stock fund. The Italians used the word "banco" meaning a heap of money or an accumulation of stock. Also read Macleod, *Theory of Credit.*

2 *Banking*—p. 12.

3 *Money and Banking,* Pp. 108-9.

cing of the country."[1] "Taken in its general acceptance word 'Bank' expresses among us today the business which consists in affecting, on account of others, receipts and payments, buying and selling either money of gold and silver or letters of exchange and drafts, public securities and shares in industrial enterprises ; in a word, all the obligations whose creation has resulted from the use of credit on the part of states, societies and individuals."[2]

Functions of a Bank. From this comprehensive definition we get an idea of the usual functions of a bank. In the first instance, it attracts *deposits* on which it pays a reasonable rate of interest. Deposits may be received on Current Account whereby the banker incurs an obligation to repay legal tender on demand, on Savings Bank Account in which case the depositor is not allowed to draw more than a fixed sum of money more than once or twice a week, and on Fixed Deposit Account which is withdrawable only on the expiry of the period for which it has been entrusted to the bank. Secondly, the money thus collected, together with the capital raised from the shareholders, is used for giving *loans* to the business people at higher rates of interest. The difference between the rates of interest charged from their debtors and paid to their creditors (depositors) constitutes their profit. Loans are sometimes given against personal security or against mortgaged property but more often against commercial bills of exchange which they *accept and discount* on behalf of their clients. Thirdly, they facilitate the *transfer* of money from one part of the country to another where they have their branches. Fourthly, they keep valuable articles in safe custody and act as agents to their clients for the purpose of buying gold, silver, shares and securities, for the collection of dividends and for the payment of insurance premia,[3] etc. Some banks issue notes and act as bankers to the government of their country. They are commonly called Central Banks. In addition to these, there are specialised institutions created for specific purposes only, *viz.*, Industrial Banks, Land Mortgage Banks, Post Office Savings Banks, etc.

The banker's general utility services include (a) the issue of various forms of credit instruments such as letters of credit, traveller's cheques and circular notes ; (b) the transaction of foreign exchange

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1 *Report*—p. 453. An attempt has been made to define Banking by the addition of Section 77—F to the Indian Companies Act of 1936. According to this, a "Banking Company" means a company which carries on, as its *principal business*, the accepting of deposits of money on current account or otherwise subject to withdrawal by cheque, draft or order notwithstanding that it engages in addition in any one or more of the following forms of business etc. etc."

2 Gautier quoted by Conant—*Principles of Money and Banking*, Vol. II. p. 207.

3 "Ordinary banking business consists of changing cash for bank deposits and bank deposits for cash ; transferring bank deposits from one person or corporation to another, giving bank deposits in exchange for bills of exchange, government bonds, the secured promises of business men to repay, and so forth" Sayers *Modern Banking*, p. 22.

business ; (c) the acceptance of bills of exchange ; (d) the distribution throughout the country of supplies of legal tender currency ; and (e) the giving of opinions as to the respectability and financial standing of customers.

Loans Make Deposits. It has been observed that one of the most important functions of banks is to lend money. The amounts lent are seldom taken away by the debtors. They are left in the bank and drawn upon from time to time by means of cheques. Every loan by the bank, therefore, creates a deposit. Such deposits are called 'Credit Deposits' to distinguish them from 'Cash Deposits' which are created by spare money being entrusted to the banks by their creditors. The same amount is shown as a loan to an individual in one ledger and as his deposit in the bank in the other.[1]

It will be wrong to suppose that the whole amount lent by the banks will be allowed to remain with them. Some borrowers will certainly withdraw a part of their deposits in cash to meet their liabilities to others. It is, however, possible that these "others" may be customers of this or other bank and the amount lent by the banks may eventually return to them. In other words, so long as the loan is due, a deposit to that amount will be outstanding in the books of some bank or banks.

How Much May the Banks Lend ? The amount which a bank may safely lend depends upon the amount that is likely to be withdrawn by depositors in a given period of time. If the depositors are expected to withdraw more money or more frequently, the percentage of eash to deposits must be large and *vice versa.* If the banks keep more cash than is required for meeting normal liabilities, the money will remain idle and the profits of the bank will dwindle. But if the banks, in their greed for making profit do not keep sufficient cash in reserves there may be a sudden run on them and they may have to close their doors for good. It may be mentioned in passing that one of the causes of successive bank failures in India has been a very low percentage of cash to deposits usually maintained by the Indian banks.

Circumstances Determining the Adequacy of a Given Cash Reserve. To earn profits at all the banker must maintain confidence. To maintain confidence he must maintain an adequate degree of *liquidity* in his assets. The perfectly liquid asset is of course cash itself. The more cash a banker holds the more obviously can he, without any difficulty of any kind, offer cash in exchange for deposits. The amount of cash reserve maintained by a bank depends upon the business condition of the community in which the bank is operating and more particularly upon the kinds of clients

1 Referring to Great Britain, Mr. Hartley Withers has remarked that out of the total deposits of the five biggest commercial banks amounting to 1,666 million pounds, 1,249 millions consists of credit deposits and only 417 millions of cash deposits. See his *The Meaning of Money.*

that it has and the nature of their business. Thus, in a manufacturing and commercial community, where exchanges are numerous and rapid it might be necessary to maintain a relatively larger reserve than would be necessary in an agricultural community where exchange transactions are much less frequent. Even in agricultural areas, it might be necessary to maintain a larger reserve in the busy season than in the slack season. Again, where the use of cheque as currency is widespread the bank can exercise a good deal of economy in respect of cash reserve but such economy cannot be practised in a country like India where the bulk of payment has to be made in metallic money and notes. A bank with an extensive town business may require a larger amount of cash reserve than a bank with wider connections with the rural population of the country. A bank with numerous branches can centralise the reserves and thus carry on its business with a smaller reserve than if each of the branch banks was independent of the other. Lastly, the amount of a banker's reserve varies considerably with the state of public confidence and with the general conditions of trade. In times of depression and business uncertainty, when confidence is at a low ebb and people lack faith in the future, greater cash reserves are maintained by the banks than in prosperous times, when faith runs high, when trade shows promise and when many customers, intent upon "making hay while the sun shines," apply to the bankers for accommodation to finance new business ventures or to extend their existing operations.

Unit *vs* **Branch Banking**. This, however, does not mean that a bank with numerous branches is, in all respects, preferable to a bank with no branch at all. The American banks, for instance, are unit banks and often have distinct advantages over the English banks which are well-known for their network of branches. Let us, therefore, try to understand the relative merits of the two types of banking systems.

A bank with a large number of branches enjoys certain economies of large-scale production and more particularly, the advantages of division of labour. It can invest its resources in different occupations and thereby strike a better balance between safety and profitability. Some of its more able employees can devote their whole time to the broader problems of bank management, such as the distribution of assets, the rules to be applied to collateral security, offered by businessmen seeking loans, and the recruitment of staff etc. Then, as we have seen, such a bank can afford to hold a lower cash reserve in each office, for one office can draw on another. The cheapness of doing remittance business is much increased by the conveniences of the branch system and the risks can be more widely distributed. For example, it is known that in addition to general depression which may affect all industries, particular industries are subject to secular rises and declines as a result of changes in tastes and technique of production etc. In so far as declining industries are strongly localised, unit banks depending on these areas may incur severe losses whereas the losses incurred by branch banks in depressed areas may be offset

by profits earned by branches of the same banks in more prosperous areas.

In actual practice, market conditions are so localised that unit banks are more useful than branch banks. Moreover, the local banker has direct personal knowledge of the business men and knows all about their respectability and credit-worthiness. But as against this it might be urged that a unit banker has to make decisions himself and thus to face the odium of refusing accommodation while the manager of a branch can easily shift the responsibility to the Head Office without losing grace with the clients. Thus the advantages seem to be overwhelmingly in favour of the branch banking system. It makes for efficiency in administration and economy of resources. In some countries where legal restrictions and local jealousies have led to the creation of unit banks, as in the U.S.A., some of the advantages of branch-banking have been secured by appointing, what is called "correspondent banks" in important centres.[1]

Bank's Investment As Secondary Reserve. Apart from maintaining a reserve of cash, a bank has to arrange its investments in such a way that they constitute a supplementary or secondary reserve. As a matter of fact the bank has in actual cash only a percentage of its outstanding demand liabilities, *i.e.*, liabilities payable in cash on demand. Increased need for cash can be met only through the sale of some of the bank's assets. These assets, therefore, should carry the least amount of risk and should be readily saleable without any loss otherwise it will not be possible for the bank to get an additional supply of ready money where an occasion demands it. The bank has to arrange its investments very cautiously both from the point of view of security and saleability. It should first give loans against commercial paper representing goods in transit or against stocks and shares of well-known companies. This investment should be so arranged that a few bills are constantly maturing and that a good many should mature before the day on which large withdraw ls are likely to be made. It may next consider the advisability of advancing money against staples such as wheat and cotton for which the farmers usually receive certificates from the warehouses. Loans may also be given against household property but not without thorough investigation because these securities do not have a ready market and may not be disposed of without sustaining heavy losses.

How Do Banks Create Credit Money? The banks can create credit in two ways, *viz.*, (a) by issuing notes, and (b) by giving loans to business men and creating deposits in their favour.

Every bank issuing notes has to keep adequate reserves. As all the notes issued are not likely to be presented for the purpose of being exchanged in metallic money, only a small percentage of notes is backed by metal and the rest is covered by securities. These notes

1 *See* also an excellent article on Unit Banks in the *Eastern Economist* of February 18, 1949.

circulate as money so long as the credit of the bank is good. A bank issuing notes thus creates credit and provides purchasing power to the business community.[1]

As regards the second point it has been shown that banks do not accept deposits for the mere fun of keeping money with themselves. They use them as basis on which they organise credit with which they finance economic activities. "Every unit of money that is not kept in actual circulation or not hoarded but is deposited in banks serves the purpose of at least five units. This may appear as a paradox but will be apparent on little explanation. Let us assume that banks keep 20 per cent of their deposits as cash with themselves and the rest they lend. This is the usual practice. And if the sums advanced are again deposited with the banks 4/5ths of these will again be lent and so on *ad infinitum*. This is, of course, on the assumption that the banking system is sufficiently developed and the amount of money going in actual circulation by actual withdrawals from the banking organisation as a whole is small. Thus the total cash with banks satisfies claims of depositors up to at least five times its amount. Claims of money on banks may either be in respect of original savings deposited or in respect of advances made subsequently therefrom. If banking is developed sufficiently, the cash percentage may safely be reduced to 15 in which case every unit deposited serves the purpose of 7 units."[2]

Advantages of Banks. From what has been said above, it will appear that banks render very useful service to the community. They collect from thousands of depositors small sums of money which would have otherwise remained idle or would have been used up for unproductive purposes. These sums of money are put at the disposal of more capable business men who do not possess sufficient money of their own but who are quite competent to guide and control the productive operations of the country. "Thus a bank acts as a medium for transferring capital from those who possess it but do not know how to use it or have not the time to use it to the advantage of all concerned—depositors, bankers and borrowers alike."[3] The existence of a sound and competitive banking system is in itself an encouragement to saving, thrift and economy. The small depositor is brought to appreciate the facilities for safe investment which the banks provide and even the poorer classes become imbued with feelings of security and prosperity and are encouraged to develop the "saving habit." The banks create credit which is the 'life-blood' of trade and industry and mobilise the possible wealth of the country for industrial and agricultural operations. By dealing in bills, selling drafts or orders and issuing letters of credit banks facilitate the transmission of money. They also help the movement of commodities within the same country and from one country to the other. They

1 Also see Sayers—*Modern Banking*, Pp. 212-32.

2 Thakur—*Organisation of Indian Banking*—p. 15.

3 Wadia and Joshi—*Money and the Money Market in India*, p. 151.

promote habits of saving and thrift and afford to customers, through the use of cheques, records of payments and receipts which cannot be disputed. Modern banks are financial service stations. "The Western Banker is a financial focus of the community. He is in constant touch with investors, and can help in selling stocks and bonds. He can advise on market securities, investments, credits and budgets and a thousand and one financial questions."[1] In fact, from a simple dealer and broker in money he has become the arbiter of a nation's industrial organisation and even of "the fate of the nation" as Conant says in his *Principles of Money and Banking*. Such banks as are allowed to issue notes adjust the amount of different kinds of circulating media to the shifting requirements of trade and economise the use of precious metals by replacing them by paper currency. They serve as a central institution—a Banker's Bank—which fulfils the same function in relation to all banking institutions within the country that a simple bank fulfils in relation to individual depositors and holders of funds.[2]

Requisites of Sound Banking. Banking is an essential economic activity of human society upon the extent and sufficiency of which depends its proper economic advancement. It is, therefore, necessary that it should be organised and controlled by the most competent people who have the necessary *ability* and *honesty* to inspire public confidence. Such people should be familiar with the requirements of each industry and every section of the community and should be qualified to adapt recognised banking practices to their peculiar circumstances. Since the fate of commerce and industry of a country is intimately linked with its financial organisation, it is also desirable that the banks should be run on purely *national* lines. Foreign capital and experts may be imported, if necessary, in the initial stages but they should on no account be allowed to divert their policies in channels prejudicial to the interests of the nation they profess to serve. The success of banking also depends upon the nature and *state of literacy* of the masses. It should, therefore, be the duty of banks to educate the people in matters of thrift and investment. Last, but not the least, the presence of a *sympathetic Government* always willing and able to appreciate and promote the legitimate aspirations of its subjects is also a necessary condition for sound banking.

Balance Sheet of a Bank. Banks are essentially business institutions and have to publish periodical statements of account for

1 J. W. Mullay, quoted by B. R. Rau, in *Present-day Banking in India*, Pp. 142-43.

2 According to Mr. Thakur, the services of Banks run in the following directions :—

(*i*) Mobilisation of savings and the inculcation of the habit of thrift.
(*ii*) Organisation of credit on the basis of money deposited with them.
(*iii*) Financing of human activities.
(*iv*) Exchange and transmission of money.
(*v*) Management, control and issue of Bank Notes—a form of money usually adopted by all the principal civilised countries.
(*vi*) Regulation of money market.

the benefit of their clients. These statements which show the nature of business transacted and the general financial condition of the institution to which they relate are called 'balance sheets'. A typical balance sheet has two columns—Liabilities and Assets. The 'liabilities' side includes the amounts of money which the bank owes to its share-holders, depositors and others. The 'Assets' side gives details of sums which other people owe to the bank and over which the bank has a claim. It should be remembered that each bank follows its own method of presenting account to the public. Owing further to the difference in the nature of business undertaken by each institution the balance sheets are bound to differ in minor details. There will, however, be no difference in the major points brought out in each statement. Items which are usually entered in the 'Liabilities' column are :—

1. *Paid-up Capital.* It is the price of the shares actually paid-up and frequently represents only a fraction of the nominal value of the shares called the subscribed capital. This amount the bank owes to its share-holders.
2. *Reserve.* It consists of the undivided profit which may have been set aside for unforeseen emergencies. This is also owed to share-holders.
3. *Public Deposits,* that is, balance of the Government funds entrusted to the bank.
4. *Other Deposits* include loans given by private individuals to the bank for a fixed period (Fixed Deposits) or with the intention of drawing upon them at will (Current Accounts) or at specified intervals and in limited amounts only (Savings Bank Deposits).
5. *Acceptances* denote the amount of bills which the bank accepted on behalf of its clients and to the extent of which it is liable to the drawers or payees.
6. *Profit* accruing to the bank in the period covered by the balance sheet.

The following items ordinarily appear on the 'Assets' side :—

1. *Cash in hand and at other banks.*
2. *Cash at call and short notice,* that is, the amount of loans which can be called up forthwith or at a short notice.
3. *Bills Discounted* denote the amount of money advanced against or spent in purchasing inland and foreign bills of exchange payable on maturity of such bills.
4. *Government Securities* purchased by and in possession of the bank.
5. *Other Investments* represent the amount of money spent in purchasing shares and stocks of private companies.
6. *Advances and Loans* included sums of money advanced against property, ornaments, and other tangible securities.

7. *Acceptances*, that is, the amount due to customers on whose behalf bills have been accepted and who are responsible to the bank for meeting the bills when they fall due. The amount is exactly identical with that mentioned in column of 'Liabilities' under 'Acceptances' (5).
8. *Bullion* represents the value of precious metals possessed by the bank.
9. *Dead Stock or Premises.* It shows the value of property of all descriptions on which the bank does not earn any profit or interest *e. g.*, buildings, furniture, stationery, etc.[1]

SPECIMEN OF BALANCE-SHEETS

A. IMPERIAL BANK OF INDIA

Balance-Sheet as at 31st December, 1934

Liabilities		Rs.	Assets		Rs.
Paid-up Capital	...	5,62,50,000	Cash	...	18,97,38,000
Reserve	...	5,35,00,000	Balance with Other Banks	...	5,25,000
Public Deposits	...	6,72,20,000	Investments	...	41,55,70,000
Current, Fixed and other Deposits	...	74,27,95,000	Bills discounted and purchased	...	2,59,32,000
Sundries	...	93,98,000	Loans and advances	...	26,42,44,000
			Dead Stock	...	2,45,90,000
			Sundries	...	85,13,000
Total Rs.		92,91,13,000	Total Rs.		92,91,13,000

B. STATEMENT OF THE AFFAIRS OF THE RESERVE BANK OF INDIA BANKING DEPARTMENT

As on the 30th April, 1935.

Liabilities		Rs.	Assets		Rs.
Capital paid-up	...	5,00,00,000	Notes ...	...	19,05,29,000
Reserve Fund	...	5,00,00,000	Rupee Coin	...	3,30,000
Deposits—			Subsidiary Coin	...	1,04,000
(a) Government	...	18,36,41,000	Bills Discounted	...	...
(b) Banks	...	7,82,07,000	(a) Internal		...
(c) Others	...	...	(b) External		...
Bills payable	...	43,000	(c) Government of India Treasury Bills		...
Other Liabilities	...	1,85,000	Balances held abroad		11,94,95,000
			Loans and Advances to the Government		...
			Other Loans and Advances		...
			Investments	...	5,00,00,000
			Other Assets	...	16,18,000
Total Rs.		36,20,76,000	Total Rs.		36,20,76,000

1 Read also Hartley Withers—*International Finance*,—Pp. 35-36.

Bankers' Clearing House. An important feature of the modern banking organisation is the Clearing House. It is a well-known fact that persons who do not carry cash with them pay their creditors by cheques. The people receiving these cheques rarely present them to the banks upon whom they are drawn for payments. They send them to their own bankers for collection and for being credited to their accounts. Banks thus establish claims over others in respect of cheques, bills, etc., drawn in their favour and payable by the latter. Now, if the amount of money to be collected is very great, each Bank will have to depute special clerks for going round other banks for the purpose of settling mutual indebtedness. In order to economise a good deal of time and shoe-leather, instead of going to each bank to present their 'charge' upon it, they alll meet by agreement at one place and make their settlement together. Such a place is called a 'Clearing House.' The process of clearing is very simple. All bills and cheques, as soon as they are received by a bank from its customers for collection and are duly recorded for credit of their respective accounts, are passed on to its own Clearing Department where they are sorted out and a list of money to be received from other bank is made. This list is sent through runner or clerk to the Clearing House and the amount payable by each bank is noted by its representatives. After all the cheques and bills are received and delivered, the balances are struck and each bank knows what it has to receive from and pay to each of the other banks. The differences are made up and each bank is debited or credited with the balance it has to pay or receive in the Clearing Bank's Account. The balances are not actually paid but necessary adjustments are made in the separate accounts maintained by the member banks with the Clearing House—the amount due to them being credited to, and their liabilities being deducted from, their respective accounts. The Clearing House's Account must be balanced up every evening because inter-bank payments and receipts must always be equal.

The advantages of this system are evidently many. All the large payments are made with a minimum of risk, loss of time, trouble or use of the precious metals.

Before the establishment of the Reserve Bank the Imperial Bank served as a Clearing House in India although up to 1928 all the transactions were not effected through the Clearing House, as in Bombay, and inter-bank transactions were adjusted by direct credit or debit with the Imperial Bank. The work of the Clearing House is now undertaken by the Reserve Bank at 8 places, *viz* : Calcutta, Bombay, Madras, Rangoon, Karachi, Kanpur, Lahore, and Delhi—the last named having been instituted in 1935-36. The members consist of the Reserve Bank, Imperial Bank, most of the Exchange Banks and English Banking Agency firms and a few of the better known of the local Joint Stock Banks. No bank is entitled to claim to be a member as of right and any application for admission to the Clearing House must be proposed and seconded by two members and be subject thereafter to approval of the majority of the existing

members. That the amounts which pass in this way through the Clearing are gigantic is proved by the figures of the principal Clearing Houses of India.

TOTAL AMOUNT OF CHEQUES CLEARED ANNUALLY
(in lakhs of rupees)

Year	Calcutta	Bombay	Madras	Karachi	Rangoon	Kanpur	Lahore	Delhi	Total
1929	10,94,00	6,52,35	65,73	28,02	1,25,00	7,81	8,69	...	19,81,10
1930	9,60,97	7,93,66	82,19	26,49	1,20,70	7,56	8,17	...	19,99,74
1931	8,66,97	6,66,61	50,36	24,47	1,06,56	5,71	10,67	...	17,30,65
1932	7,31,09	6,23,82	43,97	23,25	78,90	5,63	9,02	...	15,15,66
1937	9,23,68	7,62,38	91,39	31,94	83,75	11,40	11,40	15,61	19,31,66
1938	9,66,93	8,15,36	1,09,67	35,53	82,07	11,21	11,21	18,27	20,51,12
1959	10,76,11	8,37,22	97,21	35,57	94,57	...	...	...	22,59,05
1943	17,40,12	24,42,31	2,00,02	1,02,41	...	1,02,41	78,32	1,02,41	47,68,50
1944	23,51,59	22,30,97	1,27,37	1,24,54	...	1,24,57	74	1,29,94	50,95,69
1947	28,42,25	25,49,08	3,78,00	...	...	1,42,66	...	1,56,37	72,31,38
1948	26,55,26	27,38,53	4,02,02	...	...	1,40,46	...	1,48,68	66,86,54
1950	23,56,18	25,99,80	3,74,64	...	...	1,28,56	...	1,40,30	61,97,52

SUMMARY

Definition of a Bank. It is difficult to define a bank especially in India where the indigenous money lenders do not perform any of the recognised functions of a bank and yet constitute an important part of the Indian Money Market. Broadly speaking a bank may be defined as a credit institution which receives deposits, gives loans and purchases precious metals, shares and securities on behalf of its clients.

Functions of a Bank.

(*i*) To attract deposits—Current, Savings and Fixed.
(*ii*) To give loans.
(*iii*) To accept and discount bills of exchange.
(*iv*) To transfer money from one place to another.
(*v*) To keep valuable articles in safe custody.
(*vi*) To act as agent for its clients.
(*vii*) Some banks issue notes and act as Government Bankers and are called Central Banks.
(*viii*) Some banks perform special functions only, *viz.*, Industrial Banks, Land Mortgage Banks, etc.

Loans Make Deposits. People deposit money by delivering cash at the bank (Cash Deposits) or by borrowing money from the bank and leaving it there to be drawn at a later date (Credit Deposits).

How Much May a Bank Lend ? A bank ought to keep a reasonable portion of cash to meet its current liabilities in respect of deposits and invest the rest in different kinds of securities maturing at convenient dates. The amount of the reserve will depend upon the business conditions of the community and the requirements of their clients. Normally more money will be required in a manufacturing country or in a country where the use of cheques is not properly developed A bank with nnmerous branches can afford to keep a smaller reserve than a bank whose branches work independently of each other.

Unit *vs.* Branch Banking. Branch banks enjoy the advantages of division of labour and large-scale enterprise. They can employ their funds more economically and distribute risks more widely. There is better administrative control. Unit banks, on the other hand, ensure better contacts between the management and the clients and a correct appreciation of the credit worthiness of those seeking accommodation from them. On the whole branch-banking is more advantageous and therefore more popular.

How do Banks Create Credit ? The banks create credit partly by putting in circulation notes of a value greater than the value of the coin or bullion which it holds as "backing" for them and partly by giving loans to businessmen and creating deposits in their favour.

Advantages of Banks. They collect the small savings of the poor and make them available for productive operations, transfer of investment and thrift. The Central Banks control and regulate the supply of money and co-ordinate the activities of other financial institutions of a country.

Requisites of Sound Banking. Since the economic advancement of a community depends upon sound banking, it is essential that the management of banks should be entrusted to competent people who have the will and ability of inspiring universal confidence. Banks should also be run strictly on national lines adequately supported by a sympathetic government.

Balance Sheet of a Bank. A balance sheet is a statement of accounts. It has two sides—the 'Liabilities' side representing amounts which the bank owes, and the 'Assets' side showing amounts which the bank has to receive. The 'Liabilities' column includes paid-up capital, reserves, deposits, acceptances and profits while the 'Assets' side includes cash in hand and at other banks, cash at call and short notice, bills discounted, investments, acceptances, bullion and deadstock.

Banker's Clearing House. In civilised communities payments are made and received by cheques with the result that the banks have frequently to receive huge amounts from some banks in respect of cheques drawn on others and deposited with them and to pay to several other banks in respect of cheques drawn by their creditors and presented to others for encashment. In order to avoid the trouble and inconvenience of inter-bank transfer of money, they decide upon a particular bank and all debts are settled through it. Such a bank is called a Clearing House. In India the Reserve Bank functions as a Clearing House for approved banking institutions except where it has no branch. In such places the Imperial Bank takes the place of the Reserve Bank.

QUESTIONS

1. What is a bank ? [Delhi Inter. 1929]

2. What services are performed by bankers ? Is the village *mahajan* a banker in the true sense of the term ? [U.P. Inter 1928]

3. What is a cash reserve ? On what does the adequacy of a given cash reserve depend ?

4. Explain :—

   (*a*) "Loans create deposits." [Calcutta B.A. 1930]

   (*b*) "Bank Deposits have in modern times changed from deposit of cash to deposit of credit". [Calcutta B.A. 1927]

5. By what principles should a banker be guided in granting credits to his customers ? What investments are most suitable from the banker's standpoint ? [Punjab B.A. 1933]

6. Give a specimen of the balance sheet of a bank and bring out the significance of each item.

7. Write brief explanatory notes on :—

   (*a*) Requisites of Sound Banking.

   (*b*) Bankers' Clearing House. [Agra B.A. 1932 and 1934]

CHAPTER XVI

BANKING AND THE INDIAN MONEY MARKET

Constituent Members of the Indian Money Market. The Indian Money Market consists of:—

1. The Indigenous Bankers.
2. Joint Stock Banks, including :—
   (*a*) Indian Joint Stock Banks,
   (*b*) Foreign Exchange Banks ; and
   (*c*) Imperial Bank.
3. Reserve Bank of India.

Some writers also include in the Banking System the Post Office Savings Banks, the Co-operative Banks, the Land Mortgage Banks, Stock Exchanges, and Insurance Companies, etc., but since they concentrate on special forms of banking only and do not ordinarily come in contact with other members of the money market, some of them will not receive more than passing reference here.

The Indigenous Bankers.[1] It is a well-known fact that a system of banking eminently suited to her requirements was in force in India long before the introduction of scientific banking in England.[2]

The ancient bankers combined banking with trading with the result that with sudden changes in trade conditions several of them came to grief. The survivors, known by a variety of names such as *Mahajans*, *Sahukars*, *Banias*, *Shroffs*, *Chettis*, *Multanis*, etc., continued to render useful service to industry, trade and agriculture and are still the only means of banking assistance in many parts of the country. According to the Census of 1931, the number of people engaged in banking, money-lending and allied activities is a little over 3 lakhs but no authentic statistics are available about the total volume of their business. Considering, however, that the total volume of internal trade (which must be at least ten times that of the external trade) would amount to Rs. 2,500 crores[3] of rupees, it is quite reasonable to expect that a very large part of it must be financed by indigenous agencies. This conclusion is further reinforced by the fact that even in cities like Bomb ay, Calcutta and Delhi, where there is no dearth of modern banks, we find native merchants settling their

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1 Dr. L. C. Jain has distinguished between an indigenous "Banker" and a "money-lender"—the former term being applied to those individuals or private firms, which, in addition to giving loans, either receive deposits or deal in *hundis*—the latter to those which make loans but do not usually receive deposits or deal in *hundis*. *The Monetary Problem of India*, p. 55.
The Central Banking Enquiry Committee have tried to make the distinction clear by saying that while the bankers finance trade and industry rather than consumption, the money-lenders finance consumption rather than industry.

2 For an excellent account of the work of these bankers from the 17th century onwards, see Muranjan, *Modern Banking in India*, Pp. 7-25.

3 See K. T. Shah—*Trade, Tariff, and Transport*, p. 122.

transactions by means of *hundis* at rates definitely *higher* than the bank rate. (The business of the indigenous banks is purely a family concern and passes from one generation to another. The money-lenders receive no banking education beyond what they learn in the course of their business and from the previous experience of their firms.) Their operations are free from formalities and delays. They are available at all times. Their establishments are small and economical. Their accounts are simple and economical, yet accurate and efficient. No audit is needed and no balancesheet is to be prepared. No separate accounts, funds or establishments are kept for banking and trading. (They lend money against different kinds of securities including land, jewellery, and commercial paper. Few of them use cheques and accept deposits—immense inherited wealth being sufficient for their lending operations. They discount and purchase *hundis* offered by their clients and help the movement of funds from one centre to another by drawing *hundis* upon their agents and friends. Some speculate in money, grain, cotton and securities, some are jewellers and shopkeepers and some act as agents of mercantile firms. Some of them hold shares in industrial concerns and advance money against deposit of shares as well as against the security of fixed capital of industrial establishments. Some of them receive funds from the public too on current as well as fixed account and pay far higher rates of interest than what either joint-stock banks or co-operative banks would offer—between 3 per cent and 9 per cent. In short, they finance the agriculturist, the petty artisan and the small trader, assist in the movement of crops to consuming areas or to the ports, and distribute all kinds of goods in the interior of the country. Some of them provide even the long-term capital needs of industries. They are of very real service to the business community and of very great assistance to the joint-stock banks of the country. Under present conditions the banks run on modern lines can never hope to be able to get into sufficiently close touch with the affairs of the vast trading community in India to enable them to grant accommodation to more than a few of these traders direct and it is in their capacity as middlemen that the *Shroffs* prove of such great service. Their real importance, however, lies in the fact that they lend money against almost any conceivable security without insisting upon embrassing formalities. They are ferquently criticised[1] for keeping mysterious accounts and for charging usurious

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1 The most questionable practices connected with money-lending are :—
(*a*) demand for advance interest ;
(*b*) demand for a present for doing business, known as *girah-kholai* (purse-opening) ;
(*c*) taking of thumb impression on a blank paper with a view to inserting any arbitrary amount at a later date if the debtor becomes irregular in payment of interest ;
(*d*) general manipulation of the account to the disadvantage of the debtor ;
(*e*) insertion in written documents of sums considerably in excess of the actual money lent ; and
(*f*) taking of conditional sale deeds in order to provide against possible evasion of payment by the debtor. *Report of the Central Banking Enquiry Committee*, p. 77.

rates of interest but the critics forget the risk and the cost of collection that the *Sahukars* have to incur in dealing with their illiterate and irresponsible clients. Moreover, "the pleasant manners, alertness and personal interest of the bankers and money-lenders alike are invaluable assets which are lacking in the case of modern Indian joint stock banks."[1] These bankers will do well to change their obsolete methods and to bring them more into line with the methods of modern banks especially in the matter of audit of accounts, publication of balance sheets, use of bills and cheques, the necessity and the prompt payment and receipt of money and the conduct of business strictly in accordance with legal requirements.

These bankers have fallen on evil days lately. Their decline may be attributed to their antiquated methods, to the legal difficulties under which they labour, the apathy of the legislators, provision of cheap and safe remittance facilities and the competition of other credit agencies especially co-operative credit societies. The majority of them are conservative and jealous of each other, lack adaptability and initiative, and continue antiquated methods of business, often in isolation and secrecy, making impossible the creation of public opinion which alone can enable them to sustain their role. There is no regular organisation of indigenous bankers, each doing business independent of the other, though, in some places, they have formed guilds which are more of a social than a business character. Reference may here be made to a few associations of indigenous bankers, such as the Shroffs' Association in Bombay, Ahmedabad and Calcutta, the Marwari Chamber of Commerce and the Multani and Shikarpuri Bankers' Association in Bombay. There is, however, none for the purpose of enunciation and adoption of uniform policies or exchange of commercial intelligence. Nor is there any arrangement for imparting systematic banking training or education, the members of the family learning more by instinct and family tradition than by any other method. Many of the money lenders have a small deposit business, or dealing in other people's money, which is a fundamental feature of organised banking. Consequently, the savings of the country, instead of being mobilised as deposits and made available for exploiting the resources of the country have remained inert, and the evils of money-lending have increased. They also deal in stocks and shares which is not the business of a scientific banker who must avoid speculative dealing at all costs. They have ceased to advance money against land in provinces where Land Alienation Act is in force and their operations will tend to be further curtailed by the passage of agrarian bills such as those which have been recently passed in the Punjab and are contemplated in other provinces. Loss of *hundis* owing to exporting firms having established their own branches and heavy stamp duty on bills have also proved their undoing. They work more or less independently of joint-stock banks. In the busy season the indigenous bankers do approach the

1 Jain—*The Monetary Problems of India*—p. 163.

joint-stock banks for accommodation ; but for the most part of the year the bazzar rates are not influenced by the bank rate. The Central Banking Enquiry Committee have suggested that in order to restore the indigenous banks to their ancient place of pride, such of those as are engaged in banking proper or are prepared to shed their business other than banking, should be eligible to be placed on the approved list of the Reserve Bank in the same manner as the joint-stock banks, provided they keep proper accounts and have them periodically audited by recognised auditors.[1] "With the same purpose in view, the Reserve Bank and the commercial banks in India may use such indigenous bankers who are members of the Reserve Bank system as agents for collection of cheques and bills in the same manner as they may use a joint-stock bank or a co-operative bank."[2]

Sir J. B. Taylor drafted a tentative scheme[3] in 1937 in order to ensure the linking of the indigenous bankers with the Reserve Bank of India. It laid down the minimum limit of capital of all private banks seeking direct access to the Reserve Bank at two lakhs of rupees which should be increased to five lakhs within five years. It did not insist on compulsory deposit for this experimental period of five years provided that the amount of time and demand liabilities remained less than five times the capital. Other conditions which should be stipulated for such banks were :—

(1) They must confine their business to banking proper as defined by the Indian Companies Act of 1936. Any other business that they might be conducting should be wound up within a reasonable time.

(2) They must maintain proper books of account and have them audited by registered accountants. The Reserve Bank will have the right to inspect the accounts and call for any information necessary to determine the financial status of the banker.

(3) They must file with the Reserve Bank the periodical statements prescribed for scheduled banks. They must also, in the interest of their depositors, publish the returns prescribed for banking companies by the Companies Act and be liable to the same penalties for non-compliance.

(4) The Reserve Bank will have the right of regulating the business of the bankers on proper banking lines when necessary.

(5) If they satisfy the above conditions they will have the privilege of re-discount with the Reserve Bank against eligible paper, the right to secure advances against Government paper, and remittance facilities similar to those for the scheduled banks.

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1 *Report*—p. 107.

2 *Ibid*—p. 109.

3 See Annexure to the *Statutory Report* of the Reserve Bank, Pp. 56-58.

Those indigenous banks who would not be eligible for direct Reserve Banking facilities under this scheme might organise themselves on a joint-stock basis into discount companies with membership confined to themselves within a given area. The Reserve Bank would be prepared to discount their papers when presented through such discount houses subject to the usual central banking principles. By this method the indigenous banker would not be required to make such a complete change in the present banking methods.

This scheme was to be a tentative one for a term of five years but before the end of this period the Reserve Bank was to frame proposals for legislation if it thought fit further to co-ordinate or regulate the position of private bankers. It was likely that such legislation would take the form of a separate Bank Act as suggested by the Banking Enquiry Committee or otherwise to standardise and co-ordinate the status of their registered private bankers on lines in consonance with the scheduled banks.

The scheme was circularised among the bankers concerned for opinion. The replies received, however, were not quite sympathetic. The Bombay Shroff Association, for instance, felt that "no valuable privilege has been held out to the indigenous banker and no facility has been offered hitherto to make him go out of his way to curtail his activities and to adopt forms of business which are convenient to the joint-stock banks but which would be somewhat inconvenient to him." The Association has no objection to speculative activities being regarded as a disqualification for direct relationship with the Reserve Bank but was not willing to give up dealing in gold and silver ornaments and silver utensils as merchants because the discontinuance of such a lucrative ancestral business would certainly ruin the prestige of the indigenous banker in his locality. It was also opposed to the publication of returns as prescribed for banking companies by the Companies Act because in its opinion such publicity was bound to do them more harm than good although its members would always be prepared to supply necessary information if and when required by the Reserve Bank.

These views[1] precluded the possibility of any direct connection being established between the indigenous bankers and the Reserve Bank but the bank had hinted at the development of an open bill market as a means of establishing some sort of indirect contact between the two. If such a market were established it would be possible for the Reserve Bank to extend its open market operations to trade bills as it has done in the case of Government securities and this would give first class indigenous bankers the closer and possibly ultimately the direct relationship which they desired without compelling them to modify the essential character of the business or to submit to unduly rigid control.[2]

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1 For a stricter opposition of the scheme read Appendix C. *Statutory Report of the Reserve Bank*, Pp. 68-71,

2 *Statutory Report*, p. 43.

In its endeavour to make finance available to the agriculturists at cheap rates, the Reserve Bank also formulated a scheme, in January 1938, for providing finance for the marking of agricultural produce through the agency of the money-lender. Under the scheme, the Bank offered to rediscount, at concession rates through scheduled banks, the bills of approved money-lenders drawn for making advances to agriculturists against the security of produce, on the condition that the benefit of the low rates was passed on to the agriculturists. Unfortunately, this scheme also had to be abandoned on account of the difficulties pointed out by the scheduled banks. These difficulties were :—

(*i*) The smaller agriculturist did not usually borrow against the security of his produce. He required finance more for crop production than for its marketing. He generally obtained it by keeping a running account with a money-lender and would not, therefore, agree to commit himself to bills payable on a fixed date.

(*ii*) The scheduled banks were not in a position to gauge the money-lender's credit readily, nor would it be possible for them to dictate the rate of interest which the latter should charge to the cultivators against produce bills.

(*iii*) First class bills were discounted at very fine rates owing to keen competition, and there would, therefore, be little scope for scheduled banks to re-discount such bills with the Reserve Bank.

(*iv*) The debt relief measures passed during the period of the depression had introduced an element of uncertainty into the sphere of agricultural credit.

In his inaugural address before the All-India Shroffs' Conference in July 1951, the Governor of the Reserve Bank indicated that the primary responsibility of producing a constructive scheme for the indigenous bankers with the Reserve Bank must rest on them. For this purpose, a change in their traditional outlook and practices was necessary.

Joint-Stock Banks. Under this heading are included all banks registered under the Indian Companies Act. Their foundation was laid in the eighteenth century when the Hindustan Bank was established in 1770. The early joint-stock banks were all under European control and management but during the past thirty years or so[1] many purely Indian banks have sprung into existence assisted by the Swadeshi Movement of 1905 and by the high tide of economic revival which swept over the country during the post-war period. The Bank of India and the Indian Specie Bank were established in Bombay in 1908 and were followed by a perfect stream of new floatations.

1 Really speaking, the purely Indian joint-stock bank—the Oudh Commercial Bank—was started in 1881 followed by the Punjab National Bank in 1894 and the Peoples Bank of India 1901.

Many of the new banks confined themselves to legitimate banking business but a large number engaged in other business in addition and could hardly be called banks. They made rapid progress before the war but unfortunately many of them were swallowed up by the banking crisis of 1913 which gave a great set-back to Indian banking.[1] The crisis was caused by the fraudulent dealing of selfish and incapable directors who frequently combined trading with banking and offered unusually high rates of interest to depositors. "There was want of co-operation and co-ordination between the Indian banks themselves, the attitude of the English and Presidency Banks was unsympathetic and hostile and even the Government was indifferent spectator if not averse to their existence and prosperity".[2] The first important failure to take place was that of the Peoples Bank of India and the loss of confidence caused by the failure of the Bank resulted in a very large number of other failures the principal being that of the Indian Specie Bank. Since those events, confidence was largely restored. But in April 1923, the Alliance Bank of Simla failed. The effects of the failure of this old established bank might have been disastrous but for the prompt action of the Imperial Bank which dealt with the situation in close association with the Government of India. The Imperial Bank undertook to pay the depositors of the Alliance Bank 50 per cent of the amounts due to them. A failure was averted and a critical period passed through with little difficulty. During 1923, the Tata Industrial Bank which was established in 1918 was merged in the Central Bank of India.

In 1932 there was another crop of bank failures. Altogether 23 banks closed their doors, Madras heading the list with 9, Bengal following with 4, Bombay, the United Provinces, the Punjab, Bihar and Orissa accounting for two each and Mysore and Travancore for one each. In 1936, 40 banks failed in Travancore where too many banks had sprung up in short time.

The end of June, 1938, witnessed a banking crisis in South India in the failure of the Travancore National and Quilon Bank Limited. The bank held a very important position among the South Indian joint-stock banks. It had a paid-up capital of Rs. 25 lakhs and had 78 branches. As soon as the news of the failure was received, the Reserve Bank sanctioned special credit limits to banks in South India and these limits were later doubled. But for this timely action of the Reserve Bank a major banking crisis would have been precipitated.

The pace of expansion accelerated during the Second World War and continued till August 1947 when the disturbances completely dislocated the banking system in the affected areas. Nevertheless,

1 During 1913-14, over 100 banks registered under the Indian Companies Act with total subscribed and paid-up capital of about Rs. 15·1/2 and Rs. 16·1/2 crores, respectively failed.

2 Thakur—*Organisation of Indian Banking*, p. 33.

commercial banking in India as a whole presented an encouraging picture and even recorded further expansion.

The following statement gives details about these banks since 1946 :—

Year	Deposits (in lakhs of Rs.)	Cash in Hand (in lakhs of Rs.)	Cash at Bank (in lakhs of Rs.)	Bills Discounted and Purchases (in lakhs of Rs.)	Loans and Advances (in lakhs of Rs.)	No. of Offices
1946	986,91	70,96	109,37	45,26	413,79	5,588
1947	989,78	75,44	106,19	42,47	390,46	5,254
1948	950,85	69,65	102,64	41,35	386,76	4,868
1949	831,11	68,62	102,60	32,75	362,74	4,534
1950	828,01	53,52	79,97	44,05	374,62	4,432

The business of the joint-stock banks consists in receiving deposits of all kinds—current, saving and fixed and in advancing loans against bills of exchange and immovable security in towns and against grain, cotton, piece goods etc., in the villages. They do not rediscount their bills nor do they do the business of bank acceptances but they freely undertake agency and safe custody work. They transfer money from one place to another and buy and sell shares on behalf of their clients. Owing to the competition of non-Indian exchange banks and the small margin of profit realised on foreign exchange business the Indian bankers prefer to employ their funds in internal business of a more profitable character. Hence, they "practically take no part in the financing of India's foreign trade from the stage at which exports leave her ports or to the stage at which imports arrive thereat."[1] Loans are given for short periods and against certain forms of security only. In the bigger towns, where stock exchange securities are available, a large part of their advances is made against the hypothecation of these securities. In rural areas, where such securities are not available, advances are made against personal security with two signatures to the promissory note and against hundis. The most popular method of lending is the cash credit account by which an advance is made against a promissory note signed by the borrower and secured by the hypothecation of bonds, shares or commodities. The debtors pay interest only on the amount used from day to day and the banks can curtail or withdraw the credit at any time. The result is that they do not take any material part in the financing of industries, unlike the German or Continental banks in Europe. Nor do they have any direct relations with the agriculturists in the marketing of staple produce. Except for certain parts of Southern India, their role in rural credits is usually that of an intermediary furnishing part of the credit to the indigenous

1 *Central Banking Enquiry Committee Report*—p. 374. Also read p. 312.

bankers and in a small degree to the landlord or the co-operative banks. They are admittedly in the best position to finance the movement and marketing of crops by making short-term advances against produce and "in order that they may be able to do so the arrangements for the marketing of crops must be improved by (*a*) the grading and standardisation of staple and of contracts, (*b*) proper storage facilities, and (*c*) the creation of properly regulated local as well as forward markets. Regulation of markets is necessary by the enactment of special marketing acts which will provide for the licensing of brokers, the conditions of their business, settlement of disputes, use of standard weights and measures, prohibition of illegal deductions, publication of marketing information and constructions of warehouses."[1]

The following figures give a good idea of the progress of these banks relatively to other banking institutions in the country :—

Table A.

Year	Imperial Bank		Exchange Banks		Joint-Stock Banks (Scheduled)	
	Head Offices	Branches	Head Offices	Branches	Head Offices	Branches
1918	3	68	...	48	47	197
1937	3	163	...	99	151	829
1940	3	390	...	101	180	1,177
1946	3	358	...	77	77	2,422
1947	3	362	...	80	80	2,545
1948	3	367	...	74	78	2,520
1949	3	377	...	75	77	2,412

Table B.

(in crores)

Year	Capital and Reserve			Deposits			Cash Balances		
	Exchange Banks	Imperial Bank	Joint-Stock Banks	Exchange Banks	Imperial Bank	Joint-Stock Banks	Exchange Banks	Imperial Bank	Joint-Stock Banks
	£	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
1918	3·9	7·2	6·6	61·3	59·6	41·1	22·3	17·0	9·6
1928	18·7	11·0	12·3	71·1	79·2	65·3	8·0	10·6	8·7
1937	12·8	11·4	14·9	73·2	81·1	108·5	10·5	13·4	18·1
1940	12·8	11·6	17·2	85·6	96·0	125·0	16·5	24·8	28·5
1946	...	11·8	43·4	180·8	271·6	611·2	23·6	42·4	115·5
1947	...	11·8	46·5	173·5	286·6	619·8	31·0	44·8	121·5
1948	...	11·9	50·7	166·9	280·0	594·9	17·7	43·6	115·2
1949	...	11·9	51·0	166·6	250·5	509·5	19·5	66·8	92·6

1 *Statutory Report* of the Reserve Bank of India published under Section 551 of the Reserve Bank of India Act, in 1937—p. 8.

It will be seen that before World War II the branches of the exchange banks increased from 48 to 101 and that of the Imperial Bank from 68 to 390, the branches of the joint stock banks increased from 197 to 1,177. Also, while the deposits of the Imperial Bank increased by 48 per cent and of the exchange banks by 39 per cent, the deposits of the joint-stock banks have gone up by 176 per cent.

This rapid development had been due to (*a*) rapid industrialisation of the country, (*b*) increased income, (*c*) growth of the habits of banking and thrift, (*d*) the Swadeshi Movement, and (*e*) the fall in the value of land (during and after depression) which induced people to turn to banks as a better source of investment.

The progress was retarded during the War period. After the War, while the number of branches of the exchange banks decreased to 75, the number of branches of the Indian joint stock banks was more than doubled. The Indian banks also showed much greater improvement in capital, deposits and cash balances than other banks.

It should, however, be remembered that the Indian Commercial Banks are smaller as compared to similar banks in other progressive countries and fail to inspire greater public confidence owing to the practice of keeping dangerously low cash balances, especially by the smaller banks, as the following table will show :—

JOINT-STOCK BANKS

Percentage of Cash to Liabilities on Deposits

Year	Class A. Banks with capital and Reserve of Rs. 5 lakhs and over.	Class B. Banks with Capital and Reserve between Rs. 1 and Rs. 5 lakhs.
1910	12	—
1913	18	16
1917	25	21
1920	28	18
1929	14	13
1932	13	17
1935	23	16
1936	16	18
1937	17	16
1938	14	15
1939	17	15
1940	23	18
1941	19	21

It is obvious that the banks have not benefited by the sinister experience of the pre-war period. Considering, however, that the banks hold a large part of their deposits in easily marketable Government securities and that they can have their bills easily re-discounted

at the Reserve Bank, the condition cannot be regarded as alarming. It will, however, be better for everybody if a minimum percentage of cash to liabilities is fixed by law.

Other causes of slow growth are :

(1) Lack of support and encouragement from the Government, public bodies, Municipalities, Port-Trusts and Universities and the Courts of Wards ;
(2) Competition of the foreign exchange banks, which, as we shall presently see, have appropriated a large part of the profits accruing from the internal trade of the country ;
(3) Competition of the Imperial Bank which enjoys valuable privileges which have been denied to the other banks.
(4) Frequent bank failures in the past discouraged investment in bank shares which are regarded as highly speculative even today ;
(5) The Indian laws of inheritance make it unsafe for the banks to give loans on the security of immovable property ;
(6) Many banks work with inadequate capital and reserves and, therefore, suffer from many handicaps. They have, for instance, to offer unduly high rates of interest to attract deposits, and to be able to pay them, they have often to undertake risky business. Moreover, to attract deposits, many of them have to open branches which do not prove profitable owing to the competition of stronger rivals ;
(7) Scarcity of trade bills and the absence of bank acceptances, so that the banks are compelled to invest a relatively large proportion of their funds in gilt-edged securities ;
(8) Their work is conducted in English but the proportion of Indians who can read and write English is very small ;
(9) Very poor staff ;
(10) Most of the Directors are not businessmen or financiers possessing sufficient ability and experience to inspire confidence or to develop a technique suited to Indian conditions.

Most of these difficulties can be eliminated or considerably mitigated provided the Government gives them encouragement and possibly concessions such as those which have been granted to the co-operative banks. The Reserve Bank can also help them in many ways, particularly for opening branches in places where banking facilities do not exist. In such cases the Reserve Bank should offer to deposit a certain amount with every new branch opened in a town without a commercial bank and provide rediscounting facilities at special rates. The Reserve Bank can also help the joint stock banks in the country in forming a Banker's Association with the following objects :—

(*a*) to develop the practice of 'one man, one bank' ;
(*b*) to arrange for the pooling of information regarding the credit of borrowers in different parts of the country and to create, if necessary, a special organisation for the purpose ;

(*c*) to create an *esprit de corps* among banks and to take suitable action in cases where some banks are found guilty of spreading false rumours about other banks ;

(*d*) to encourage certain uniform practice in the best interests of the banks and the general public ; and

(*e*) to make representation to government, the Reserve Bank, and public or semi-public bodies and to take such steps as may be considered necessary in the general interests of banks working in the country.[1]

But it must be distinctly understood that expansion is not always desirable. In fact, the existing banks require consolidation rather than expansion. "In a large country like India it is preferable for joint stock banking to expand by means of new branches of existing banks rather than by more new banks. The former course has the advantage of dividing the risk of the parent banks over a number of branches and overcoming the effects of local crisis much better than would be the case with small independent institutions. The opening of new branches would, on the whole, lead to an increase in business and in prestige.[2]" Moreover, some of the impediments to the development of the credit presented by our laws of inheritance should be removed. The banks should develop the practice of "one man, one bank" and should launch upon a more progressive policy of giving clean advances against the personal credit of borrowers of undoubted means and character. They should also permit their customers free use of vernaculars in the various fields of banking, including cheques pass-books, paying-in-slips, etc., and improve their staff and management.

Foreign Exchange Banks.[3] They have their head quarters in foreign countries and are, therefore, not registered in India. Although they do not publish any statement relating to their Indian business separately, it is an open secret that their Indian business is only a small percentage of their total business which is undoubtedly stupendous. Two[4] of them are mainly concerned with tourist traffic while the rest perform more or less the same functions as the Indian joint-stock banks. Their chief importance lies in financing India's foreign trade which the purely Indian banks are unable to do. This is done by drawing funds from foreign countries[5] and investing

1 Tannan's Notes on Joint Stock submitted to National Planning Committee.

2 L. C. Jain—*The Monetary Problems of India*, p. 193.

3 The name is a misnomer. Joint-stock banks are allowed to undertake foreign exchange business and the foreign exchange banks are also joint stock banks.

4 Messrs Thomas Cook and Sons and American Express Company.

5 At one time the Banks carried on their operations in India almost entirely with money borrowed elsewhere, principally in London—the home offices of the Banks attracting deposits for use in India by offering rates of interest much higher than the English banks were able to quote. Within recent years, however, it has been discovered that it is possible to attract deposits in India on quite as favourable terms as can be done in London and a very large proportion of the financing done by the Exchange Banks is now carried through by means of money borrowed in India.

them in the purchase of bills drawn against imports and exports to and from India. The financing of the import trade is for the most part done by branches outside India, the Indian branches' share in the business consisting principally in collecting the amount of the bills at maturity and in furnishing their other branches with the information as to the means and standing of the drawers of the bills. It is as regards the export business that the Indian branches are more immediately concerned. The exchange banks have practically a monopoly of the export finance in India. The bills against exports are largely drawn at three months' sight and may either be "clear" or be accompanied by the documents relating to the goods in respect of which they are drawn. Most of them are drawn on well known firms at home and are easily discounted in London. Bills purchased in India are sent home by the first possible mail, so that, presuming they are rediscounted as soon as they reach London, the exchange banks are able to secure the return of their money in about 16 or 17 days instead of having to wait for three months which would be the case if they were unable to rediscount. In this way the exchange banks are able to limit the employment of their own resources to a comparatively small figure in relation to the business they actually put through.[1] They also help the foreign trade of the country by making loans against shipping and other documents and by issuing foreign letters of credit. They also finance imports of bullion and keep the traders in distant places informed about their mutual financial position from time to time—a facility very essential for safe and prosperous international trade.

As the exchange banks are controlled and financed by foreigners, it may be argued that the share of the Indians in the foreign trade of their country is negligibly small (less than 15 per cent of the total). Other incidental losses have also to be reckoned in. There is reason to fear that branches of exchange banks, even when they are opened at the request of Indian clients, encroach on the financing of domestic trade as well. The cheap deposits raised by exchange banks place them in a strong competitive condition which is further reinforced by the natural tendency on the part of their customers to open and keep accounts with them. Besides, exchange banks have been accused of compelling Indians to insure their goods with foreign insurance companies on the usual grounds, which, however plausible on their face, cannot but limit the growth of Indian enterprise in this field.[2] This involves the loss to India of a large amount in the shape of commission, brokerage, and insurance paid to non-Indians. They are not subject to legal restrictions, even to the statutory obligations to which the Indian joint-stock banks are subject. Their ditectors and share-holders are entirely foreign, and the control over

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1 For the exact mechanism of foreign trade and finance, read *Central Banking Enquiry Committee Report*, Pp. 314-320, and Muranjan, *Modern Banking in India*, Pp. 166-170.

2 Muranjan—*Modern Banking in India*, p. 166.

them being thus exercised from abroad, their accounts need not be audited by recognised auditors. They do not even publish in their balance-sheets separate information regarding their Indian business. Moreover, Indians, as a matter of rule, are not employed to posts of trust and responsibility. They have undoubtedly hampered the development of Indian joint-stock banks and have exercised great influence over the Government of India and the Secretary of State often to the detriment of Indian interests. The Central Banking Committee, therefore recommended that all non-Indian Banks wishing to do banking business in India should be required to take out a licence from the Reserve Bank and should be required to train and employ as many Indians for executive posts as may be found suitable. They have also advised that, after the establishment of the Reserve Bank, the Imperial Bank may be allowed to take to foreign exchange business or, in the alternative, that a purely Indian exchange bank should be set up with the support of the Government and the Reserve Bank. Government help can take many forms. For instance, it can give a guarantee, for, say, 'the first few years of interest on the preference capital to be raised for the purpose. Any amount so paid by the government to be repaid gradually out of the surplus profits of the bank after setting aside the amount required for payment of dividend at 3½ per cent. Government can also help by contributing annually a certain sum not exceeding 50 per cent of the annual expenses of the bank during the first five or six years. Other concessions such as exemption from the payment of income tax, certain stamp duties etc., may also be granted. The Indian joint-stock banks should also be persuaded to buy the ordinary shares in proportion to their paid up capital and reserve fund.

The following table illustrates the progress of the exchange banks since 1920 :—

Year	No. of Banks	Capital and Reserve £ (1,000)	Deposits		Cash Balances	
			Out of India £ (1,000)	In India Rs. (1,000)	Out of India £ (1,000)	In India Rs. (1,000)
1920	15	90,217	513,671	74,80,71	84,197	25,17,53
1930	18	193,616	1,196,060	68,11,44	208,923	7,70,89
1940	20	128,244	1,804,283	85,32,81	608,854	17,19,40
1941	17	105,953	1,642,138	106,73,07	481,849	13,39,75
1942	16	106,686	1,867,148	116,85,27	537,461	12,00,96
1943	16	119,855	2,054,865	140,21,13	556,537	17,24,47
1944	15	134,002	2,474,914	165,21,13	573,944	24,82,09
1945	15	152,930	3,736,055	183,73,50	2,347,231	26,82,08
1946 A	3	6,675	74,124	61,29,70	23,407	7,56,84
B	12	149,447	2,606,034	119,98,76	682,527	24,45,35
Total	15	156,122	2,680,158	181,28,46	705,934	32,02,19

A—Banks doing a considerable portion of their business in India.
B—Banks which are merely agencies of large banking co-operations doing a major portion of their business abroad.

The table below gives an idea of the percentage of cash to liabilities maintained by these institutions during the last twenty years :—

FOREIGN EXCHANGE BANKS

Percentage of cash to Liabilities on Deposits in India

	1910 %	1925 %	1927 %	1929 %	1931 %	1933 %	1935 %	1937 %	1939 %	1941 %
A—Exchange Banks[1] ...	16	13	11	14	15	12	15	19	9	10
B—Exchange Banks[2] ...	21	15	14	10	9	6	19	10	10	15

The gradual reduction in the proportion of cash to liabilities gives legitimate cause for alarm.[3] A proportion which may be considered adequate in a country like England with a highly developed banking organisation and accustomed to the use of cheques, may be regarded as inadequate in a country like India. "An Indian reserve, such as they appear to keep of from 18 to 20 per cent, would be respectable, for example, in England. But in such a country as India where banking is ill-established and hoarding more than a memory, the proportion held in reserve seems somewhat lower than perhaps it ought to be. Possibly, exchange banks have already been in smooth waters longer than is for their good."[4] Now that the proportion is even less—11 to 15 per cent—it is extremely necessary that the exchange banks should be compelled by law to maintain a fixed minimum percentage of cash balance to their total deposits in India and should not be allowed to disturb the statutory proportion by events affecting their position outside India.

The Presidency Banks. We have already hinted[5] at the

1 Doing considerable portion of their business in India.
2 Agencies of large banks doing business all over Asia.
3 Compare in this connection conditions prevailing in other countries :

Percentage of cash and other items of cash nature to total deposits

Country	1929	1930	1931	1932	1933	1934
France	15·8	18·8	29·8	25·9	21·0	...
Germany	4·6	5·1	5·8	5·4	...	...
England and Wales	25·2	23·9	22·9	21·7	22·0	...
Canada	17·2	16·7	15·0	15·3	14·7	16·1
United States	13 0	16·2	15·3	14·0	16·1	...
Australia	14·6	20·7	18·3	15·4	18·3	...
New Zealand	12·9	13·6	12·4	7·4	8·6	...

See *Commercial Banks*, 1929-31, pp. XLIII—XLIV.

4 Keynes—*Indian Currency and Finance*, p. 216.

5 Chapter XIV.

establishment of three Presidency Banks in the nineteenth century. They were private institutions but, in lieu of the capital subscribed by the East India Company and the monopoly of Government banking in cluding the privilege of note-issue entrusted to them, the Secretary and Treasurer of the banks were appointed by the Government. The Government also imposed severe restrictions[1] upon their business, *e.g.*, they were not allowed to deal in foreign exchanges or to raise funds outside India. They were not allowed to give loans for a period longer than six months or to make advances on the security of immovable property or upon promissory notes unless they bore the endorsement of two independent names. They could not give loans upon the security of goods unless either the goods themselves or titles to them were deposited with them as security. The power of note-issue was taken away from them in 1862 and the Government balances withdrawn in 1876 to be put in a separate reserve maintained by the Government and called the Independent Treasury System. Although the banks continued to receive deposits, discount inland bills and manage the public debt of India, it was realised that their popularity was confined to the presidency towns or, at the most, few commercial centres in their respective territories and that there was no co-ordination between them at all. They were reluctant to start branches except in places where they were certain to be profitable. They did not possess sufficient funds for financing the trade of the country. Bills that had been discounted in India had to be rediscounted in London which was not often practicable. There was thus stringency of money in the busy season and redundancy in the slack season causing violent fluctuations in the rates of interest and discount called *peaks* and *troughs*. The Government controlled currency by its monopoly of note-issue while the credit was controlled, if it was controlled at all, by the Presidency Banks and there was no connection between the two. The Government maintained their own Independent Treasury[2]. The surplus of Government revenues was locked up at headquarters where it was allowed to rot especially at a time when its presence was most keenly felt in the market. The Government were reluctant to make these funds available to the Presidency Banks for the simple reason that they did not wish to entrust public money to private institutions and to create a false sense of confidence in the Government.

In short, as Mr. Keynes put it, "with no central reserve, no elasticity of credit currency, hardly a rediscount market, and hardly a bank rate policy, with the growth of small and daring banks, great increase of deposits, and community not habituated to banking and ready, at the least alarm, to revert to hoarding even when it was seemingly abandoned there were to be found most elements of weakness and few elements of strength."

The Imperial Bank. In order to extend banking facilities

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1 These restrictions added to the safety of the Banks especially at a time when the country was faced with banking crisis.

2 The system was abolished in 1921.

and to bring about a better understanding between the different members of the money market, many schemes for the establishment of a Central Bank were put forward but the idea did not materialise until the three Presidency Banks were amalgamated into the Imperial Bank in 1921. The capital of the Imperial Bank is Rs. 11·25 crores divided into shares of Rs. 500 each. The paid-up capital and reserve on the 31st December, 1934, were Rs. 5·62 crores and Rs. 5·35 crores, respectively. Its governing body, which is responsible for general superintendence and control of Bank's affairs, is called the Central Board. There are three other Boards at Bengal, Bombay and Madras which are known as Local Boards. They are elected by the share-holders and carry out the policy of the Central Board in the light of conditions prevailing in their respective territories. The Central Board of Directors consists of :—

(*a*) the Presidents, Vice-Presidents and the Secretaries of the Local Board ;

(*b*) one person elected from amongst the members of each Local Board ;

(*c*) a Managing Director and a Deputy Managing Director appointed by the Central Board ; and

(*d*) not more than two non-officials nominated by the Governor-General-in-Council.

Representatives of any new Local Board which may be constituted may be added at the discretion of the Central Board. The Deputy Managing Director and the Secretaries of the Local Board are entitled to attend the meetings of the Central Board but are not entitled to vote. The Deputy Managing Director is entitled to vote in the absence of the Managing Director. The Governor-General-in-Council nominates an official to attend the meeting of the Central Board but he is not entitled to vote.

The Bank, until recently,[1] enjoyed Government balances free of interest and acted as a Government banker in all other respects, *viz.*, remittance of funds on behalf of, and advancing loans to the Government and management of Public Debt. It also exercised certain central banking functions. Thus it held deposits for other banks which regarded them as part of their cash balances and made advances to other banks under certain conditions. "The presence of a bank whose presence and stability were beyond all doubt and which could keep their cash balances was expected to have a very uplifting effect on local banks."[2] The bulk of its business was, however, transacted with private customers. The Bank was not allowed to make loans for a period exceeding six months and was debarred from making advances on the security of immovable property. The Bank has an office in London but it was not permitted to deal in foreign exchange except on behalf of the Government. The Bank was not authorised to borrow

1 Till the creation of the *Reserve Bank* in April, 1935.
2 Muranjan—*Modren Banking in India*, p. 78.

or receive deposits payable outside India or to maintain a foreign branch for these purposes. It was thus a purely commercial bank with private share-holders raised to the doubtful status of a central bank by the Government. The situation was by no means satisfactory and steps had to be taken to replace it by a full-fledged central bank in April, 1935. Needless to say that most of the restrictions under which the Imperial Bank laboured have since been withdrawn.[1] Its Central Board has been reconstituted so as to relax Government control. It has ceased to be the banker of the Government except in places where the Reserve Bank will have no branches. It has been freed from the previous sanction of the Governor-General to establish Local Head Offices and Local Boards and has been fully empowered to shape its financial policy. Many other restrictions have also been withdrawn. For example, the Bank may now open branches, buy and sell bills of exchange not exceeding nine months if they relate to the financing of seasonal agricultural operations, borrow money and accept deposits from outside India, make advances against goods hypothecated to it and make advances and open cash credits on the security of approved shares' securities and debentures. The Bank will thus have a free hand for financing trade and commerce. But it will continue to occupy a privileged position as the sole agent of the Reserve Bank which is not fair to other banks.

The following extracts from the balance sheets of the Imperial Bank will give some idea of its working and usefulness.

IMPERIAL BANK OF INDIA

Balance Sheet as on December 31.

[In crores of rupees]

Years	Capital Paid up	Reserve	Pubic Deposits	Private Deposit	Loans	Cash Credit	Bills	Cash in hand and at Bank	Govern-ment Sec-urities	Other investment	Dead Stock	Net Profit
1921	5·62	4·33	6·8	65·7	18·6	25·2	9·9	13·6	11·1	1·2	2·3	130·5
1928	5·62	5·22	7.9	71·3	21·6	27·5	12·4	10·5	19·0	2·7	2·8	153·0
1932	5·62	2·17	7·0	68·3	6·6	19·0	1·9	20·9	30·3	1·6	2·6	1 7·5
1939	5·62	5·60	...	81·5	10·7	30·9	6·6	11·0	38·2	·4	1·3	...
1940	5·62	5·62	...	87·8	7·3	21·1	3·8	24·8	47·6	·4	1·9	...
1945	5 62	6·07	...	259·3	30·2	33·4	9·3	41·6	148·9	5·2	1·6	...
1947	5·62	6·25	...	286·6	...	...	89·2	42·9	164·2	...	1·5	122·7
1950	5·62	6·32	...	231·6	3·3	...	98·7	31·5	121·5	...	1·6	125·5

During its 30 years of successful career, the Imperial Bank has rendered useful service to the country. It has started 161[2] branches

1 *Vide* The Imperial Bank Amendment Act of 1934.

2 The Presidency Banks before amalgamation had 54 branches. The Imperial Bank was required to open, within five years of its establishment, 100 new branches of which one-fourth were to be at places directed by the Governor-General-in-Council. "To no part of the Imperial Bank Act of 1921 did public opinion attach greater importance than this undertaking to extend banking facilities." Muranjan—*Modern Banking in India*, p. 78. In 1941, the number of branches was 398.

26 of which are situated in places, where banking facilities were practically unknown before. With the help of Government balances entrusted to it, it has been enabled to rediscount inland bills on behalf of approved firms and to give loans against promissory notes and overdrafts, etc. It has also given the public every facility for remitting money between its branches at reasonable rates. The great differences which existed between the Hundi and Bazar Rates have now been reduced and huge divergences between Madras, Calcutta and Bombay money rates have been equalised to a great extent. The bank has helped a number of banks in times of crisis, *e.g.*, the Alliance Bank of Simla, and has cultivated relations with Provincial Co-operative Banks by allowing them the advantage of over-draft system. Although it was not allowed to issue notes, it held Government balances, did Treasury work and functioned to a certain extent as a bankers' bank. With a view to assisting the money market in the busy season it could obtain loans from the Paper Currency Department up to a maximum of Rs. 12 crores at bank rate, subject to a minimum rate of 6 per cent for the first four crores and 7 per cent for the remaining eight crores of rupees on the security of internal bills of exchange or hundis of an equivalent amount. Commercial banks, including exchange banks, maintain balances with it and approach it for accommodation against eligible securities, mostly Government paper, in time of difficulties. Nevertheless, its business and public usefulness have not grown at the rate expected by the public. The deposits have *decreased* from Rs. 87 crores in 1920 to Rs. 74 crores in 1934 in spite of its reputation as an *Imperial Bank* and its numerous branches. It has not been allowed to take any part in financing the foreign trade of the country which has been attributed to a desire to protect the foreign exchange banks who have established a lucrative monopoly in this country. Even regarding the provision of finance to industries and agriculture it has not been able to fulfil the high expectations made in the beginning. With the help of free Government money averaging about Rs. 20 crores[1] it has competed with, rather than helped other members of the money market and they have made no secret of their resentment against the partial attitude of the Government. The Bank is managed mainly by non-Indians who are less accommodating to their native clients presumably because they do not get sufficient opportunities of

1 IMPERIAL BANK

Government Deposits

[Lakhs of Rs.]

Year	Deposits	Year	Deposits
1921	22,20	1930	13,91
1926	32,54	1931	15,96
1927	10,04	1932	19,08
1928	7,96	1933	5,82
1929	20,74	1934	7,91

knowing much about their credit and character.[1] Allegations of discrimination as against different classes of customers, industries and places were made and fully substantiated by witnesses before the Banking Enquiry Committee. It has not given sufficient opportunities for training Indian apprentices or to appoint Indians to superior posts of trust or responsibility. It was not allowed to issue notes with the result that the gulf between credit and currency policy remained as wide as ever.

Since the establishment of the Reserve Bank, the Imperial Bank has ceased to be a banker to the Government except as an agent of the Reserve Bank in places where it has no branches. It still attracts large deposits on current account on which it does not pay any interest and takes greater part in the financing of the internal and external trade of the country. Nevertheless the management is still "alien and wooden." The personnel is mostly non-Indian and wedded to racial discrimination with the result that, apart from being unpopular, its administration is very costly and many of its branches are unremunerative. "The fact that the Imperial Bank is approached for accommodation by the public as much as by banks, joint-stock or indigenous, invests it with a peculiar character in the Indian money market. For it indicates that the Imperial Bank is likely to serve, to a large extent, as a buffer between the Rural Banking and the money market. In view of the past history and the vast resources and immense prestige enjoyed by the Imperial Bank, the control and guidance of the money market in India by the Reserve Bank will have to be shared, at least for a fairly long period of time, with the Imperial Bank."[2]

If the recommendations of the Rural Banking Enquiry Committee are fully implemented, the future role of the Bank in the banking structure of the country will become more important and it may be expected to undergo fairly rapid expansion, the target being the establishment of a branch or pay office in every district, *taluka* and *mandi* town and the extension of its treasury work to all places where the Reserve Bank does not have a branch. Since an important role is contemplated for the Imperial Bank, it is necessary to examine and remove the criticism which has been levelled against the special privileges granted to it and against the policy of the Bank towards other banks, such criticism expressing the genuine fear of the banking and other business interests regarding the functioning of this very important institution. So far as the criticism has been of a political nature, the Banking Committee has expressed the opinion that it has been a carry over from the past and that the change in the political status of the country has removed the causes of such complaints. But other criticisms deserve serious consideration.

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1 For further indictment of the Bank on this point read Mr. T. Goswami's Minute appended to the *Report of the External Capital Committee*, p. 24 and the *Minority Report of the Indian Banking Enquiry Committee*, pp. 263-265.

2 B. C. Ghose—*A Study of the Indian Money Market*, pp. 75-76.

First, it has been urged that entrusting Government financial business to a single commercial bank, with its prestige and other advantages, is against the country's interest because it has created a private monopoly which can harm the interests not only of other banks but also of the general public, and that the monopoly should either be strictly controlled by the State or be taken away from the Bank. The present unsatisfactory position is largely due to the fact that, while the Imperial Bank continues to enjoy the privileges which it did before, some of the important powers, which the Government possessed for controlling its policy and working were abandoned with the establishment of the Reserve Bank. In the opinion of the Rural Banking Committee, the criticism will be met by restoring the old powers to the Government.

Secondly, the majority of the senior posts in the Bank are still held by non-Indians. The Government has been assured that the services will be completely nationalised by 1955 and there is no need to kick up a row about it.

Thirdly, it has been pointed out that the Bank suffers from excessive centralisation and that, therefore, it is unlikely to interest itself in the opening up of the less-developed areas and to meet adequately the banking needs of a vast country like India. The Committee has suggested that the Bank should be made to establish more local head offices and to secure fuller representation of the different regional interests on its Central and Local Boards.

Lastly, it is urged that the Bank offers unfair competition to the other commercial banks and the working of these banks is greatly handicapped. On behalf of the Bank, it has been pointed out that the monopoly of Government business has involved the Bank in heavy losses and that it suffers a further loss in making various payments on behalf of the Governments, initially against its balances, finding reimbursement by the Central Accounts Section of the Reserve Bank in Calcutta. The Rural Banking Committee has suggested various measures by means of which the Bank will receive fair compensation for its services without making any undue profit or securing competitive advantage over other banks.

Co-operative Banks. Whether in urban or in rural areas, a Co-operative Bank means a small society or a credit institution for providing financial accommodation to its members on a co-operative basis. These banks in India are established under the Co-operative Societies Acts of 1904 and 1912. Their origin may be attributed to a desire on the part of the Government to protect the poor agriculturists against the exploitation of the money-lenders and to provide them with necessary credit at reasonable rates of interest. They also aim at educating the poor in the principles and practice of co-operation and thrift.[1] "The main results achieved may be said to be the

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1 Which are—"That an isolated and powerless individual can, by association with others and by moral development and mutual support, obtain, in his own

(*Continued*)

provision of a large amount of capital and reasonable rates of interest and the organisation of a system of rural credit which, carefully fostered, may yet relieve the cultivator of that burden of usury which he has borne so patiently throughout the ages. Knowledge of the co-operative system is now widespread ; thrift is being encouraged ; training in the handling of money and in elementary banking practice is being given."[1] In many cases the members have obtained improved varieties of seeds and manure and more efficient implements at reasonable prices. They have improved the breed of their cattle and have secured better prices for their produce. They have influenced each other's conduct, have checked bad habits, such as indulgence in drink or gambling and have fostered self-restraint, discipline, self-respect and punctuality. In short, the movement has proved most beneficial economically, socially and educationally. Co-operative Banks have also been established in urban areas where they are rendering useful service to the middle classes in general and to small traders and craftsmen in particular.

The original ideal of co-operative credit lies in making available to the needy the surplus of the well-to-do through the medium of the society but in Indian villages the well-to-do and the needy form rather distinct groups—the former dominating and exploiting the latter. Thus, instead of comprising more or less all sections of the population, the societies are often made up of the needy section only, at any rate, very largely. Even otherwise, the slender savings of the well-to-do would not be enough to meet the wants of the needy and each society is not, therefore, able to be self-sufficient, making available the deposits of wealthy members for the benefit of their less fortunate brethren. Hence funds have to be raised from outside. The structure of co-operative credit consists of the Provincial Banks at the apex, the Central Banks which are affiliated to the Provincial Banks, and the Primary Societies which are mostly affiliated to the Co-operative Central Banks.

The Primary Societies form the basis of the financial structure. They are associations of borrowers and non-borrowers—all residents of one locality—mostly shaped on the principle of unlimited liability. The knowledge that the members are severally and collectively responsible for the debts of the society makes them vigilant and serves to protect the creditors. They raise their funds from among their members in the form of entrance fees, share capital and deposits. In some provinces, *e.g.*, the Punjab, the United Pro-

(*Continued*)

degree, the material advantage available to wealthy or powerful persons and thereby develop himself to the fullest extent of his natural abilities. By the union of forces material advancement is secured and by united action self-reliance is fostered, and it is from the interaction of these influences that it is hoped to attain the effective realisation of the higher and more prosperous standard of life which has been characterised as "better business, better farming and better living."—*Maclagan Committee Report*, para. 2.

1 Report of the Royal Commission on Agriculture in India, p. 447.

vinces, Madras, and Burma, share capital plays an important part whereas in other provinces the share and non-share societies exist side by side. The Central Banking Committee are of the opinion that "the encouragement of subscription to share capital by members as a method of collection of saving is to be preferred to a system of compulsory deposits." Additional funds are raised from outside public as deposits and from the Co-operative Central Banks to whom they are affiliated. The societies lend money to their members only. Most of their work is done through agencies of an honorary character. Low dividends and voluntary services result in low cost of management and enable the societies to carry a substantial portion of the profits to the reserve fund which is a good safeguard against unforeseen losses and bad debts.

The Central Banks are federations of primary societies in specified areas and are usually located in an important town of each district. Membership is open to private individuals also. They finance primary societies and guide and co-ordinate their activities. In addition to their own capital, they collect money from the public in the form of deposits and from the Provincial Banks for the use of Primary Societies. "There has been a considerable increase in the number of societies affiliated to some of the Central Banks ; there is one bank which deals with as many as 680 societies. Where such expansion has taken place the work has become unwieldy and the co-operative character of the bank tends to become slender. In such cases even if the Central Bank is to be retained it seems necessary that societies should be grouped into banking unions."[1]

The Provincial Banks are likewise federations of Central Banks of a Province. They obtain their finance mainly from deposits from the public, from joint-stock banks and from the Reserve Bank if necessary. They finance the Central Banks and act as *balancing* centres to them. The Indian Provincial Co-operative Banks Association co-ordinates their activities and supplies information to them about the financial requirements of banks. "As a Provincial Bank is virtually in the position of a Reserve Bank in that province it should give a correct lead to the other co-operative banks on banking and financial matters. It should serve as a development department for the co-operative movement and should take an active part in the reorganisation of the movement and in the extension of principles of co-operation to other spheres. By interesting themselves in all activities calculated to tone up, consolidate and expand the movement, the provincial banks will make themselves far more useful than if they restrict their role to finance only."[2]

One more part in the structure of co-operative credit which seems to be eminently desirable is an Apex All-India Co-operative Bank to serve as a central bank to all the co-operative credit institutions of the country. So far, however, such an all-India bank has

1 *Statutory Report* of the Reserve Bank, pp. 19-20

2 *Ibid.*, p. 20

not been started but it is hoped that, with an increase in co-operative business, the establishment of an Apex Bank will not be long delayed.

It will be realised that the Co-operative Credit Movement aims at mobilising money from all the possible sources for the benefit of the Primary Societies. Its benefits are, therefore, practically restricted to members only. There were, in 1932-33, 88,705 societies of all descriptions in British India for a population of 269·5 million which means about 33 societies per 100,000 inhabitants. The Native States claimed 16,557 societies for a population of 38·8 million which worked out at 42·6 societies per 100,000 people. Corresponding figures for the whole of India were 105,262 societies for a population of 308·3 million or about 34 societies per 100,000 people. They claimed over four million members with a working capital of over 115 crores of rupees which worked out at 49 annas per head of population. The figures for 1946-49, just published, show that the number, membership and the amount of working capital of the co-operative central bank were 498; 174,000; and Rs. 62·17 crores respectively for the territories now included in the Indian Union. Corresponding figures for agricultural societies are 116,913; 5,538,000; and Rs. 30·56 crores. There were also five central land mortgage banks with 6,493 members and Rs. 5·16 crores working capital. The primary land mortgage banks numbered 268 with 139,000 members and Rs. 4·01 crores of working capital. The number and membership of non-agricultural societies were 20,999 and 3,317,000 and their working capital was Rs. 54·11 crores. The number of non-agricultural insurance societies was 18.

These imposing array of figures, however, do not reveal the real state of affairs and a closer scrutiny shows that the position is far from satisfactory. One-third of agricultural societies are classified as D or E which means that they were not working properly or were on the verge of liquidation.

On the familiar assumption that a rural family consists of five members on the average, the membership of four million means that about 20 million people in India have been touched by the Co-operative Credit Movement. Considering, however, that 224 millions of persons, representing 71 per cent of Indian population, are supported by agriculture and that rural indebtedness is about Rs. 600 crores, the movement does not appear to have done much to ameliorate the economic distress of the masses. "Applying the two tests of the proportion of the rural population that has benefited from it, and the proportion of the rural financial need supplied by it, the progress of the movement must be pronounced to be disappointing in the country, especially in the provinces other than Bombay, the Punjab and Madras".[1] Moreover the growth of the movement is uneven and lopsided. A State-wise analysis of the societies shows that while the four main Part A States, namely, Madras, Bombay, West Bengal and

1 Panandikar—*Banking in India*, p. 74.

Uttar Pradesh, account for more than 50 per cent of the total number of societies, in the other Part A and most of the Part B, C and D States the progress of the movement has been insignificant. Its progress has been retarded for want of proper understanding of co-operative principles. For instance, the members do not take much interest in the working of societies which are virtually controlled and administered by officials. The number of defunct, cancelled and 'under liquidation' societies is on an increase every year and those which are working are not doing large business on account of frozen assets. Loans given to members are generally inadequate and are recovered with great difficulty. The rates of interest in some provinces are very high. This is inevitable to some extent because the intermediate agencies, *viz.*, the primary societies, the central banks and the provincial banks need for their working expenses the difference between the rate of interest at which money is obtained for the movement from outside and that at which it is lent to the borrowing cultivators. Many managing committees are inefficient, display a factious spirit, are not properly controlled by the general body of members, and appropriate too large a proportion of the loans for themselves. Members are frequently selected without care. Loans are often given to members recklessly and their periods are extended without proper reasons. Members delay repayment of loans even when they are able to pay, office-holders neglect taking action against defaulters. Partiality and nepotism destroy the loyalty of members and high rates of interest often compel them to knock at the door of the *sahukar.* Moreover, "the fundamental principle of true co-operation is lacking. Overdues are highly excessive. Audit is defective. Control is inefficient."[1] Short-term, intermediate and long-term loans are not clearly distinguished. No wonder, therefore, that the village money-lender is still the principal source of finance for the rural population.[2]

Another cause of the failure of the co-operative movement is the failure to realise that credit organisations alone can never provide an effective remedy for the indebtedness of the cultivator. His position can only be improved if the full force of the co-operative movement is brought to bear on him at every point in the sphere of education, of better living, of better farming and of marketing. The present tendency, therefore, is for the credit institutions to take non-credit activities in an ever-increasing measure. And, indeed, in the Reserve Bank's *Review of the Co-operative Movement* for 1939-46, published in 1948, stress has been laid on this aspect in the following words : "One would not, therefore, be far wrong if one suggested that the greatest contribution of the war to the co-operative movement was the shifting of the emphasis from the credit aspect to its productive

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1 Evidence of the Managing Governor of the Imperial Bank before the Central Banking Enquiry Committee.
Also read pages 136-140 *C. B. E. C. R.*

2 For a more critical analysis of the present position and suggestions for reform read the *Statutory Report* of the Reserve Bank, pp. 21-26.

and distributive functions, or more generally, to its multi-purpose potentialities—a long-felt need for imparting that richness and balance which is necessary for the proper development of the movement."

The co-operative movement can be made more helpful and efficient by giving effect to the recommendations of the Agricultural Commission, the Central and Provincial Banking Enquiry Committees and the Provincial Committees on co-operation. According to these recommendations, the official control should be reduced if not completely done away with. The primary functions of the co-operative department should be education, supervision and the control of audit and the financing agencies should be made entirely responsible for working, loans and deposits. This will make the movement more popular in the country and promote a sense of responsibility among the members. For the purpose of audit, inspection and supervision, primary societies and central banks of different areas should be grouped into district unions and registered under the Co-operative Societies Act. Loans should be granted for economic purposes only and no tenderness should be shown in dealing with defaulters. Efforts should be made to reduce the rate of interest charged from the members of primary societies and to encourage savings in years of plenty for use in years of scarcity. Partial and dishonest office-bearers should be sacked and steps should be taken to avoid the control of societies and central banks passing into the hands of a few powerful members. The banks should be managed by persons well trained in banking and co-operation and the use of cheques should be encouraged, especially for inter-bank transfer of funds. There should also be a greater co-operation between the agricultural and the co-operative departments.

Perhaps a few words on the progress of co-operative finance during and after World War II will not be out of place here. Since the central and provincial co-operative banks are the main source of funds for the primary societies, the review will be confined to these institutions only. As is well known, the War brought about a betterment in the condition of the borrowing classes, at least of those agriculturists above the margin of subsistence, thanks to the rise in prices of agricultural produce, and even loans which might have been considered frozen before 1939 began to be realised. There was also a tremendous increase in fresh deposits. Deposits, which stood at Rs. 18·34 crores in 1939 shot up to Rs. 32·66 crores in 1946 while loans outstanding, which were Rs. 19·93 crores in 1939 remained more or less steady at that figure after the War. Some of the banks, therefore, found it necessary to do more of what is generally regarded as commercial banking business, as the available funds were found to be too large to be absorbed by the co-operative societies alone. In short, it may be stated that the effects of war-time prosperity on the co-operative central banks were an increase in deposits leading to an increase in working capital and the almost stationary nature of loans outstanding due to prompt repayments. These trends were somewhat reversed in the period subsequent to 1946, though it is not possible to make

an exact assessment of the position owing to the partition of the country in 1947. On the whole, the central banks have been very prosperous since 1939. The same can be said about the provincial banks also except, perhaps, in the provinces most adversely affected by partition, *viz.*, East Punjab and West Bengal. Some of them, as for instance, the Bombay Provincial Co-operative Bank, have become so strong that they have been entrusted with the work of the Provincial Agricultural Credit Corporation envisaged by the Agricultural Finance Sub-Committee (1945), namely, to make finance available to all credit-worthy agriculturists in the State.

Land Mortgage Banks. The co-operative societies give loans for short periods only but the agriculturists also require money both for the purpose of redeeming their past debts and for improving their lands which they cannot normally repay in a short period. Hence, the problem of long-term credit is of equally great importance especially to the land-holding classes. This problem is attempted to be solved through Land Mortgage Banks. In countries where such banks have been started, they have been greatly helpful in setting tenants and share croppers on land and thereby they have assisted the implementation of several kinds of land reforms. They have enabled farmers to carry out various improvements on land, to acquire cattle-herd and thus develop dairy farming, to purchase different types of agricultural machinery and to raise the output from land. They have also enabled farmers and their organisations to build up soils and various types of rural industries and to undertake irrigation and other projects. In fact, one can say without any fear of contradiction, that, but for the land credit institutions, the developments in the sphere of agriculture in most of the European countries which we see to-day would not have been possible.

Land Mortgage Banks are generally of three kinds : "The strictly co-operative is an association of borrowers who raise credit by the issue of mortgage bonds bearing interest and made payable to bearer and is well illustrated in the German Landschaften. The commercial type is represented by Credit Foncier of France which works for profit and declares dividends. The third type, the quasi-co-operative, has a mixed membership of borrowers and non-borrowers, operating over fairly large areas and formed with share capital and on a limited liability basis." The commercial land mortgage banks may perhaps be better suited to financing big landlords or *Zamindars*. So far as relief to small agriculturists and owners of small holdings is concerned, the co-operative type is the most suitable. The poor ryots with small holdings cannot secure credit except through organisations based on mutual association and guarantee, and the co-operative land mortgage bank is a legitimate application of that principle. The Indian banks are organised on the co-operative principle although, strictly speaking, they are quasi-co-operative in character. They are conceived as limited liability associations of borrowers with a few non-borrowing individuals thrown in for attracting initial capital as well as the business talent and organising capacity

needed to make the management efficient. As these banks require large sums of money for long periods, a part of the capital is raised from the shareholders and the rest is subscribed and guaranteed by the Governments. As against ordinary credit societies with unlimited liability where greater emphasis is laid on mutual knowledge of and control over one another, in the case of Land Mortgage Banks with limited liability, greater care has to be exercised in the selection of directors who should be perfectly business-like and competent to evaluate property and to enforce prompt repayment of loans.[1]

In India there are only five central land mortgage banks and 263 primary societies, of which Madras and Mysore alone account for as many as 198 societies. The only States which have central mortgage banks are Madras, Mysore, Cochin, Bombay and Orissa. Uttar Pradesh, Madhya Pradesh, Assam, Ajmer-Merwara and Madhya Bharat have no central mortgage banks but have a few primary societies which are being looked after by their respective Provincial Co-operative Banks. But these have made no substantial progress nor much contribution for the development of agriculture. Some idea of the extent of financial assistance that is being made by these banks to agriculture can be had from the fact that at the end of 1948-49 the total amount of loans outstanding in the books of primary societies was only Rs. 4·73 crores. The total resources of the five central mortgage banks were a little less than Rs. 6 crores. This is negligible as compared with the capital that is actually required for the development of agriculture. Even of this amount, the Madras State alone accounted for Rs. 4·70 crores, the share of Mysore, Cochin, and Bombay being about Rs. 50 lakhs, Rs. 16 lakhs and Rs. 49 lakhs respectively. Thus it is only in south India that there has been some growth in land mortgage banking, while in the rest of India, it has failed to make any impression.

These banks are expected to advance loans for the redemption of old debts, improvement of land and methods of cultivation and the purchase of land in special cases. In actual practice, however, they have concentrated on lending funds for the redemption of prior debts and have paid scant attention to land improvements or to improvements in the methods of cultivation. Perhaps this is understandable. Most of the banks were started during the period of depression and with a view to saving the farmers from losing their lands on account of their inability to meet their debts to the money-lenders. But in the altered circumstances of to-day, they must change their main role from that of rescuing the farmers from the clutches of private money-lenders to that of providing finance for development of agriculture. They must now lend freely for purposes such as improvement of land, provision of irrigation, fencing, transport and drainage facilities, construction of cottages and buildings necessary for agricultural operations and storage of agricul-

1 Also see Mr. Vakil's draft memorandum on Land Mortgage Banks submitted to the National Planning Committee, pp. 134-140.

tural produce, purchase of farms, agricultural equipments, machinery, cattle and other objects connected with the development of agriculture etc. Now that the liquidation of long-standing agricultural debts has ceased to be an important problem—thanks to higher prices realised by farmers in recent years and the various debt relief legislations—the land mortgage banks will necessarily have to take to new fields of activity such as those just mentioned in order to justify their existence. Loans are given to the members on the mortgages of their lands up to 50 per cent of their value in some provinces or up to 30 times the land revenue payable on them in others. The members' title to land, their right to alienate them, their need for loans and their repaying capacity are of course taken into account before granting loans. The period of the loans varies between 16 and 30 years in different provinces and the rates of interest vary from 6 to 9 per cent. The bulk of the funds of these banks will have to be raised by debentures, and for this purpose there will have to be in the Provinces central land mortgage banks as in Bombay and Madras. Government will also have to guarantee interest on debentures and to exempt them from stamp duty, registration fees and income-tax.[1]

Post-Office Savings Banks. These banks have been created to inculcate the habit of thrift among the working classes and the middle and lower sections of the community. Government Savings Banks were established in the Presidency towns between 1833 and 1835. The system was extended to selected district treasuries in 1870. The Post-Office Savings Banks, opened in all parts of India in 1882 and 1883, absorbed the district savings banks' business in 1886 and that of the Presidency savings banks in 1890.[2] At present the whole of the business of the savings banks is a branch of postal administration. They provide facilities for saving and investment in four ways, *viz.*, (1) by receiving deposits in their savings banks, (2) by issuing Postal Cash Certificates, (3) by purchase and sale of Government securities for the public free of charge, and (4) by offering life insurance policies to Government servants and to permanent employees of all universities established by Government.[3] They have been extremely popular among the professional classes and the intelligent middle class people. The amount of deposits increased from Rs. 4 crores in 1900 to Rs. 12 crores in 1914. The progress was arrested during the War but the money again started flowing in in 1918-19. On the 31st March, 1934, the total of savings deposits with the post-offices was Rs. 52 crores. In 1938 they were well over Rs. 77 crores. The number of post-offices doing savings bank work in that year was 23,700 and the number of depositors was over 30 lakhs and the average deposit per head was Rs. 170. The Postal Cash Certificates particularly have been instrumental in drawing a considerable amount of savings of poor people to whom perhaps no other

1 For further details read *Land Mortgage Banks*, a recent publication of the Agricultural Credit Department of the Reserve Bank of India.
2 Findlay Shirras—*Indian Finance and Banking*, p. 380.
3 Jain—*The Monetary Problems of India*, p. 128.

means of investment would have proved attractive. In order to prevent the progress from being inconveniently brisk, the Government have put limits on the deposits that can be made and the balance that can be held by a single depositor which are, at present, Rs. 750 and Rs. 5,000 respectively—the limit of balance in the case of minors being Rs. 1,000 only. These restrictions do not seem to be justified because the existing facilities are by no means excessive. There are, at present, about 12,846 banks scattered over about 500,000 villages, that is, one bank to every 40 villages. "In many cases, nearest post office savings banks are situated at a distance of about 10 or 12 miles from the village which means that the people must walk over 20 miles before they can deposit or withdraw their savings." Comparative statistics of the Postal Savings Banks of other countries[1] show that, notwithstanding the popularity of this form of investment in India, the deposit per head of population is only Rs. 2 which is certainly not very satisfactory.

It is, therefore, suggested that the existing restrictions should be relaxed subject to suitable precautions regarding sudden withdrawals. The increase of interest above the rates normally allowed by other banks does not seem to be desirable. People have also urged the adoption of cheques but the Central Banking Enquiry Committee do not favour this proposal on the ground that it would prevent the joint stock banks from opening branches at suitable places and that the Post Office would be unable to find, on its present scale of salaries, trained men who could be entrusted with the work. If higher salaries were paid the operation of the department would become prohibitively costly.[2] In order to meet the grievance that there is, at present, too great a diversion of funds outside the districts, some of the money collected through post-offices may be placed at the disposal of co-operative societies or advanced as *takavi* to individuals.[3]

1 STATISTICS RELATING TO POST-OFFICE SAVINGS BANKS DEPOSITS OF THE PRINCIPAL COUNTRIES OF THE WORLD

Country	Total Deposits (approximate)	Deposit per head of population (approximate)
	Rs.	Rs.
Canada	63,000,000	6
India	511,000,000	2
Italy	2,676,000,000	62
Japan	3,832,000,000	47
New Zealand	700,000,000	456
United Kingdom	4,380,000,000	98
United States	3,344,000,000	24

2 *Bombay Banking Enquiry Committee Report*, paras 290-291.

3 *Central Banking Enquiry Committee Report*, p. 380.

Some of the Provincial Banking Enquiry Committees emphasized the need of increasing the number of post-offices where savings bank business can be transacted. Where it would not pay to keep such post-offices open throughout the week they may be kept open for two or three days in the week. They also suggested that a limited number of postal savings bank should be kept open in the larger towns two or three evenings of the week so that the labourers and small shopkeepers may make use of them. The services of the village school masters should be used as far as possible for running them. Facilities for transferring money from one savings bank account into another should be given and accounts should be kept in local vernaculars if the depositors so desire.

If the postal banks work in concert with the Reserve Bank or the Imperial Bank of India and are reorganised in such a manner that no actual transfer of specie or currency takes place but amounts are credited or debited in the different postal centres from where and to which such remittances are made, the utility of the postal bank would be very largely increased and its popularity enhanced in proportion. Also, a new negotiable instrument or a new form of non-legal tender currency may be invented to serve as a postal cheque and should be available at very little cost to those using it. Postal banks should also engage in all legitimate banking business so that every possible banking facility may come to the door of the commonest individual in the country.

STATISTICS SHOWING THE PROGRESS OF THE POSTAL SAVINGS BANKS OF INDIA

[In lakhs of rupees]

Year	Deposits	With-drawals	Interest	Net Increase	Amount out-standing at the end of the year
1925-26	19,50	18,19	73	1,59	27,23
1926-27	20,38	18,89	79	2,28	29,50
1927-28	23,14	20,84	86	3,16	32,66
1928-29	26,24	25,39	97	1,82	34,49
1929-30	26,25	24,63	1,02	2,64	37,13
1930-31	24,36	25,50	1,04	10	37,02
1931-32	27,39	27,29	1,08	1,18	38,20
1932-33	30,96	26,86	1,15	5,25	43,43
1933-34	36,87	29,39	1,28	8,78	52,23
1934-35	38,67	37,26	1,34	2,75	58,30
1935-36	46,33	38,88	1,50	8,95	67,25
1936-37	43,38	37,40	1,45	7,43	74,68
1937-38[1]	43,27	39,76	1,46	4,97	79,65

1 Excluding Burma which has been separated from India,

Except 1930-31, deposits invariably exceeded withdrawals. It is also interesting to note that, although the popularity of the savings banks was not affected by the reduction of the rate of interest from 3 per cent (at which it had stood for 20 years) to 2½ per cent in November 1933, there was a noticeable fall in net deposits in subsequent years possibly owing to a further fall in the rate of interest to 2 per cent with effect from 1st July, 1936. On the whole the net deposits increased by substantial amounts even during the gloomy days of the economic crisis. This indicates that, in spite of the depression, considerable small savings were being accumulated and it undoubtedly lends support to the view that some of the proceeds of hoarded gold were finding their way into investments. Similarly, the value of Postal Cash Certificates had increased from about Rs. 9 crores in 1917-18 to about Rs. 64 crores in 1937-38.

During World War II, as we have seen, the activities of the Post-Offices were generally increased. Defence and National Savings

POSTAL SAVINGS

(In lakhs of Rs.)

	Cash Certificates.		Defence Savings Certificates outstandings[1]	National Savings Certificates.		Savings Banks Deposits.		Defence Savings Bank Deposits	
	Receipts.	Out-standing.		Receipts.	Out-standing.	Receipts.	Out-standing.	Receipts.	Out-standing.
1938-39	14,71	59,57	...	...	...	44,61	81,88	...	...
1939-40	10,25	57,02	...	...	...	40,57	78,32	...	...
1940-41	4,89	46,98	2,29	...	...	25,35	59,51	...	...
1941-42	3,97	39,01	4,35	...	...	21,91	52,07	11	11
1942-43	3,76	34,57	5,56	...	...	22,26	52,22	29	40
1943-44	5,50	34,64	6,97	8,65	8,65	35,22	64,18	3.59	3,98
1944-45	5,48	35,82	6,42	19,55	28 19	43,26	80,20	4,37	8,53
1945-46	6,67	38,72	5,92	23,21	51,30	74,62	155,04	1,98	10,50
1946-47	4,98	39 23	5,20	21,71	70,56	89,38	140,35	27	10,72
1st April to 14th August	1,06	37,69	...	...	...	37,68	146,82	...	6,02
15th Aug.[2] to 31st Mar.	...	-3 07	...	...	...	45,79	10,12	...	-3,16
1948-49	...	-7,49	—75	22,70	15,07	83,26	29,91	...	-4,07
1949-50	1	-11,33	—1,02	23,78	40,50	84,90	49,11	...	-4,46

as well as Savings stamps were introduced partly as a means of war finance and partly as a counter-inflationary measure. The progress of all these postal savings is indicated by the table above which also

1 Were replaced by National Savings Certificates from October 1, 1943.

2 Figures from 15th August 1947 relate to India only. Outstandings from that date represent the balance of the Indian Dominion only and do not include India's share of the earlier outstandings.

incidentally show the position before and after the partition of the country on 15th August, 1947.

Deficiencies of the Indian Money Market before 1935. Having explained the structure of the Indian Money Market, it remains for us to examine its deficiencies. In the *first* instance, the growth was not commensurate with the size and natural resources of the country as the following figures will show :—

STATISTICS RELATING TO COMMERCIAL BANKS OF THE PRINCIPAL COUNTRIES OF THE WORLD

Country	Number of Commercial Banks.[1]	Branches and[2] sub-branches of Commercial Banks	Number of Commercial Banks (including branches).[3]	Area served by one bank or branch of a bank.	Number of people served by one bank or branch of a bank.	Paid-up Capital and Reserve of all Commercial Banks.	Deposits of all Commercial Banks.	Deposits per head of population.	Loans and advances.
			p. sq. mile	sq. mile		Rs. (000000)	Rs. (000000)	Rs.	Rs. (000000)
Australia	10	...	...	...	...	...	3,996	604	3,160
Canada	10	3,772	978	978	2,749	796	6,228	599	3,805
France	8	2,727	·01	99	19,200	461	44,444	198	1,293
Germany	3,251	...	·0017	560	203,077	946	5,818	88	4,763
Japan	5,352	4,311	·018	54	17,338	2,384	11,305	135	6,546
New Zealand.	4	...	...	...	...	...	864	562	525
S. Africa	8	671	·0008	1,478	11,781	163	1,348	169	623
U. Kingdom	33	12,963	·13	7	3,424	2,453	33.200	745	1.218
U. States	18,067	...	·0048	207	7,582	19,216	84,994	620	112,000
India	102	969	·0005	1,774	329,598	2,560	2,284	6	...

While in the United Kingdom there was one commercial banking officc after every 7 square miles and for every 3,424 heads of the population, in India there was one to every 1,775 square miles and for every 329,598 heads of the population. Banks in the villages were conspicuous by their absence and even the urban areas were deprived of modern banking facilities because only 339 out of a total of 2,300 towns possessed a bank or a branch or agency of a bank. Such banks as existed were very small as compared to similar institutions of other progressive countries. The deposits of all the commercial banks were only Rs. 228 crores, that is Rs. 6 per head of the population. This compared very unfavourably with the deposits

1 Based on *Statisches Jahrbuch* which covers all the commercial banks of the country. Other banks have been excluded for the sake of uniformity.

2 Includes Ordinary or privately-owned banks only. The total number of banks, including the Ordinary Agricultural and Industrial banks and those controlled by the Government was 13,953 in 1932.

3 Relate to number of Commercial including National, State (commercial) and private banks and Loan and Trust companies existing in 1932. Owing to the system of licensing introduced in 1933, the number of licensed banks is reported to be only 19,829.

per head of other countries, including other, and perhaps less important, members of the British Empire like Australia, Canada, New Zealand and South Africa. This may be attributed to the inadequacy of facilities for attracting small deposits and to the pernicious habit of hoarding which still persists. *Secondly*, credit had not been thoroughly studied and specialised in all its various forms. There was no industrial bank and the commercial banks often found themselves involved in a type of work foreign to them. "They accept short period deposits only which should be utilised for financing commerce only but, in the absence of regular industrial banks, the ordinary banks are forced to lend to industrial concerns with the result that while the genuine and growing needs of the country are to this extent starved, the banks having neither the inclination nor the time nor knowledge to scrutinise such security as the industries offer, often find themselves involved in transactions of an imprudent character."[1] Similarly, there was no satisfactory banking provision for the financing of one great industry of the country. *viz.*, agriculture. The cultivator still lived on the mercy of the *sahukar* who continued to lend at a high rate of interest and frequently managed to purchase the produce at low prices. "If the producer has to pay anything from 25 to 100 per cent for his finance, the inducement to produce is wanting, for it means that all he makes over and above his bare living goes to his creditors. The secret of successful industry is to buy your finance cheap and to sell your produce dear. The Indian buys his finance dear and sells his produce cheap. His creditor generally fixes the price of both. The ryot feeds the financier in the fat years and the Government feeds the ryot in the lean. Trade flourishes on the labour of the backward people, for three-fourths of the people of India are unable to pay their debts."[2] *Thirdly*, it will be clear from the above table that branch banking was still in its infancy. Its extension was more a curse rather than a blessing to the rural areas because funds attracted there in the form of deposits were seldom utilised for their own benefit. They were sent out to big commercial towns for financing urban trade and industry. *Fourthly*, the credit system was inelastic for any extra demand for currency was not met by the expansion of banking credit. The Government had a monopoly of silver and paper money but, since it did not keep in direct touch with trade and commerce, it was impossible to put just as much currency in circulation as was required by the market. At any rate, there was no connection between the legal tender currency created by the Government and the credit currency created by the banks in pursuance of trade requirement.[3] That the two often went in opposite directions is amply proved from what happened after the First World War. The Government began

1 Wadia and Joshi—*Money and Money Market in India*, p. 394.

2 Evidence of Sir Daniel Hamilton before the Chamberlain Commission, Appendices, Vol. II., p. 524.

3 This defect, it is hoped, would disappear now that the Reserve Bank has seen the light of the day.

a policy of deflation of currency. During the years 1919 to 1921, more than 34 crores of rupees were withdrawn from circulation, that is, more than 10 per cent of the total volume of currency in active circulation. But deposits stood at about Rs. 226 crores on 31st December 1920, that is, at a much higher figure than on a corresponding date in 1919 and the figure was reduced by Rs. 6 crores only by 31st December 1921. It may be pointed out that the greater portion of the deflation of currency took place in 1920 when the deposit currency instead of contracting was expanding.[1] The Government also controlled the money markets by its power of purchasing exchange and of issuing treasury bills. That this was not regarded wholesome is sufficiently borne out by the following statement of the Hilton Young Commission : "The Government controls the currency. The credit situation is controlled, as far as it is controlled at all, by the Imperial Bank. With divided control there is likelihood of divided counsels and failure to co-operate."[2] Another difficulty arising from dual control manifested itself in the separation of banking and currency reserves which narrowed down the basis of the credit structure. The currency reserve was itself divided into two parts, one of which, the Gold Standard Reserve, was meant to secure the external convertibility of the rupee and the other, the Paper Currency Reserve, to secure the internal convertibility of notes into rupees. The provision for expanding currency in the busy season was inadequate. The Imperial Bank was allowed to borrow a maximum of Rs. 12 crores from the Controller of Currency with which to discount seasonal bills of exchange but the limit of Rs. 12 crores was very small because it was only about 3 per cent of the total export trade of the country. Hence, dissociation of note-issue from banking, scanty cash balances held by the banks and the restricted use of cheques, all added to the rigidity of the currency system. *Fifthly,* there was a deplorable lack of co-ordination between the different members of the Money Market. "Some of the joint-stock banks regard the foreign exchange banks as formidable rivals on account of their large resources and their ability to attract deposits at more favourable rates of interest than the joint-stock banks themselves. The penetration of the foreign exchange banks into inland business both at the ports and in the interior is also naturally looked upon by the Indian banks as an encroachment upon the latter's proper field of activity."[3] There was no regular connection between the joint-stock banks and the Imperial Bank nor between the co-operative banks and the indigenous bankers and money-lenders. In fact, there was a growing feeling among the joint-stock banks and the Imperial Bank that the co-operative banks were beginning to compete with commercial banks and indigenous bankers in forms of banking which were outside co-operation, that is, opening current accounts,

1 Vakil and Muranjan—*Currency and Prices in India*, p. 531.

2 See also the report of Foreign Experts appended to the Report of the Central Banking Committee, p. 648.

3 *Central Banking Enquiry Committee Report*, p. 394.

purchasing drafts, and selling remittances, etc. The Imperial Bank, which was until lately, the only co-ordinating agency between the component parts of the banking system, was looked upon more as an unfair rival than as a friendly co-adjutor. It had miserably failed to inspire public confidence owing to its policy of racial discrimination and owing to its desire to compete with, rather than help, the institutions it is supposed to protect. *Sixthly*, with banking system so loosely organised one was not surprised to find that "a call rate[1] of 1/4 per cent, a hundi[2] of 3 per cent, a bank rate[3] of 4 per cent, a Bombay bazar rate[4] for bills of small traders of 6.3/4 per cent, and a Calcutta bazar rate for bills of small traders of 10 per cent" could exist simultaneously showing extraordinary sluggishness in the movement of credit between the various markets.[5] It is a well-known fact that if banking is to render effective assistance to production, trade, and commerce it should secure stability in the rate of money, or in other words, in the charge for the use of capital. Violent changes in the rate for money indicate financial instability and cannot help the development of trade and industry. That the Indian money rates were very unstable can be easily proved by taking the rates of discount of the Imperial Bank for the last few years.

1 The Call Money Rate is the rate for surplus money seeking employment for a very short period, say 24 hours, and repayable at the option of either the lender or the borrower.

2 The Imperial Bank's Hundi Rate is the rate at which the Imperial Bank will discount or re-discount first class three-month bills.

3 The Bank Rate is the rate at which the Imperial Bank will ordinarily advance money against Government securities.

4 The Bazar Rates are those at which the bills of small traders are discounted by shroffs in different centres.

5 Latest figures of Indian Money Rates confirm this statement.

Month.	Bank Rate	CALL MONEY Rate.		Imperial Bank Hundi Rate	BAZAR BILL RATE	
		Calcutta	*Bombay*		*Calcutta*	*Bombay*
	Per cent	Per cent	Per cent	Per cent	Per cent	Per cent
April, 1932	4	3½	5½	6	7—8	6
Decr., 1932	6	1¾	1	4	6—7	4⅛
April, 1933	3½	¾	2	3½	6—7	4⅛
Decr., 1933	3½	2	2	3½	6—7	2⅝
March, 1934	3½	¾	2½	3½	6—7	6

BANK RATES OF THE IMPERIAL BANK AND THE BANK OF ENGLAND COMPARED

Month	1930-31		1931-32		1932-33		1933-34		1934-35	
	Imperial Bank	Bank of England.	Imperial Bank	Bank of England	Imperial Bank	Bank of England.	Imperial Bank	Bank of England.	Imperial Bank	Bank of England.
January ...	6	5	6	3	8	6	4	2	3½	...
February ...	6	4-6	6	3	7	5-6	4	2	3½	...
March ...	6	3-9	7	3	6	4	3½	2	3½	...
April ...	6	3-5	7	3	6	3-3	3½	2	...	...
May ...	6	3	7	2-7	5	2-7	3½	2	...	...
June ...	6	3	6	2-5	5	2-5	3½	2	...	...
July ...	6	3	6	2-8	5	2	3½	2	...	...
August ...	5	3	6	4-5	4	2	3½	2	...	...
September ...	5	3	7	5	4	2	3½	2	...	...
October ...	5	3	8	6	4	2	3½	2	...	...
November ...	5	3	8	6	4	2	3½	2	...	...
December ...	6	3	8	6	4	2	3½	2	...	...

The fluctuations in the case of India were rapid and great and the difference between the lowest and the highest rates were marked. The *seventh* outstanding deficiency of the Indian banking system was the absence of a regular bill market. The banks preferred to lock up their assets in Government securities rather than investing them in commercial bills because in the absence of regular (licensed) warehouses the former were much more safe and profitable than the latter. Even when bills were discounted, in the absence of adequate rediscounting facilities they were held till maturity and credit was consequently restricted. The lack of discounting and rediscounting facilities accounted for the slow growth of trade and commerce of the country. The absence of institutions for imparting expert banking education and of a comprehensive banking law were also regarded serious drawbacks of Indian banking. It is very strange indeed that while the Government had found it necessary to exercise and retain strict control over Insurance Companies, they remained so pathetically indifferent in respect of banking—a really more important type of credit institution.

In view of the serious deficiencies of the Indian money market mentioned above, *viz.*, undeveloped credit facilities which were mainly restricted to the urban areas, inelasticity of currency due to the separation of credit and currency functions, want of co-ordination, especially between the Indian money market and the bankers working on European lines, and lack of concentration of reserves in the hands of a central institution, the Hilton Young Commission suggested the immediate establishment of a Central Bank—to be called the Reserve Bank—for India.

Meaning of a Central Bank. Now, what is this Central Bank which has been agitating the public mind for over a century? Why has it been regarded such an infallible remedy for the economic ills of a nation? A Central Bank has been described as "the people's agency to govern their supply of currency and credit, free from any undue influence of politics or profits."[1] While there are substantial differences in the constitutional structure and in the statutory powers of the various central banks, their principal task consists in maintaining the stability of the value of currency both internally as well as externally and in controlling the credit situation in the country, including the rate of interest, at which credit would be available to trade and industry.[2]

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1 L. C. Jain—*A Reserve Bank for India*, p. 1.

2 "In the statutes of Central Banks adopted before the War, there is generally no mention of the primary functions of a central bank; the preamble or the opening articles usually contain a list of the operations the bank may or may not undertake. In the statutes drafted during the reconstruction period after the War the main object of the bank is specified but this is usually confined to the regulation of the monetary circulation with a view to ensuring the stable gold value of the currency. The definition of the general objective of the central banking system in the recent statutes and amendments is considerably more extensive, though striking differences characterize the formulation of this objective in various countries. Denmark alone affords an example of recent legislation defining the primary function of the central bank in terms similar to those employed in the early post-war period: according to section I of the Law of April 6, 1936, amending the statutes of the National Bank, the 'principal aim of the Bank is to maintain a safe and secure currency system in this country and to facilitate and regulate the traffic in money and the extension of credit.' In the Argentine Law of March 28, 1935, setting up a new central bank, the objective though broadly similar to that stated in the Danish law, is formulated differently; it is stipulated that the Bank should "concentrate sufficient reserves to moderate the consequences of fluctuations in exports and investments of foreign capital on currency, credit and commercial activity in order to maintain the value of the currency."

"In other countries this objective is variously defined. Thus the preamble to the Bank of Canada Act of July 1939 stipulates that the function of the Bank is 'to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade prices and employment, so far as may be possible within the scope of monetary action.' Similar but more extensive and specific views on desirable objectives for central bank policy are contained in the recommendations of the Report of the Australian Royal Commission on Monetary and Banking Systems. According to this Report, the Commonwealth Bank should in the conduct of its business, make 'the reduction of fluctuations in general economic activity in Australia' its chief consideration. 'The policy is not to fix the exchange rate and to require the economy in ordinary circumstances to adjust itself to that rate, but to keep the economy reasonably stable and to move the exchange rate, if necessary, as one means to that end.' It is further recommended that the Bank should regulate the volume of credit to the banks 'so that the latter will be induced to maintain a level of advances and deposits which will best serve the general objective of the Australian economy.' It is also added that the Commonwealth Bank should pay 'some regard' to the distribution by the banks of the volume of credit among different industries and see that the credit provided is made available 'at appropriate rates of interest.' In this connection, reference may also be made to an interpretation of the

(*Contd. on next page*)

Professor Sprague, while recounting the achievements of Central Banks, says : "The special functions of Central Banks may be grouped under three heads. They serve as fiscal agents of governments ; they have large powers of control over the currency through the more or less complete monopoly of note-issue ; and finally, since they hold a large part of the reserves of other banks, they are directly responsible for the foundation of the entire structure of credit. This last is by far the most important function of the Central Banks."[1]

Sir Banjamin Strong, Governor of the Bank of England, in his evidence before the Hilton Young Commission enumerated the duties and functions of the Central Bank as follows : "It should have the sole right of note-issue, it should be the channel and the sole channel for the output and intake of legal tender currency. It should be the holder of all the Government balances ; the holder of the reserve of other banks and branches of banks in the country. It should be the agent, so to speak, through which the financial operations at home and abroad of the Government would be performed. It would further be the duty of Central Bank to effect, so far as it could, suitable contraction and suitable expansion in addition to aiming generally at stability and to maintain that stability within as well as without. When necessary, it would be the ultimate source from which emergency credit might be obtained in the form of rediscounting of approved bills, or advances on approved short-dated securities or Government paper."

Allowing for local variations, a Central Bank, according to De Kock,[2] is expected to perform the following functions :—

1. The regulation of currency in accordance with the require-

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objectives of the monetary policy of the Federal Reserve System in the United States contained in a statement of the Board of Governors of August 2, 1937, where it is declared that 'economic stability rather than price stability should be the general objective of the policy of the system,' and 'that this objective cannot be achieved by monetary policy alone, but that the goal should be sought through co-ordination of monetary and other major policies of the Government which influence business activity including particularly policies with respect to taxation, expenditure, lending, foreign trade, agriculture and labour.'

"The definition of the objectives of the Reserve Bank of New Zealand as contained in Section 10 of the Amendment Act, 1936, represents a more striking departure from traditional definitions. The first duty of the Reserve Bank is stated to be as follows : 'It shall be the general function of the Reserve Bank, within the limits of its powers, particularly to give effect, as far as may be, to the monetary policy of the Government, as communicated to it from time to time by the Minister of Finance. For this purpose, and to the end that the economic and social welfare of New Zealand may be promoted and maintained, the Bank shall regulate and control credit and currency in New Zealand, the transfer of money to or from New Zealand, and the disposal of moneys that are derived from the sale of New Zealand products and for the time being are held overseas.' "—*League of Nations Monetary Review*, 1937-38.

1 See his contribution to *Dunbar's Theory and History of Banking*.

2 *Central Banking*, p. 22.

ments of business and the general public.

2. The performance of general banking and agency services for the State.
3. The custody of the cash reserves of the commercial banks.
4. The custody and management of the nation's reserves of international currency.
5. The granting of accommodation, in the form of rediscounts or collateral advances, to commerial banks, bill brokers and dealers, or other financial institutions, and the general acceptance of the responsibility of lender of the last resort.
6. The settlement of clearance balances between the banks ; and
7. The control of credit in accordance with the needs of business and with a view to carrying out the broad monetary policy adopted by the State.

Which of these seven functions is the most important it is very difficult to say, but a true Central Bank should always be ready to perform any of them if the conditions and circumstances in its area of operation render it necessary or desirable for it to do so. The guiding principle for a Central Bank, whatever function or group of functions it performs at any particular moment, is that it should act only in the public interest and without regard to profit as a primary consideration. For the same reason, it should not compete with the ordinary commercial banks in their day-to-day business except when compelled to do so in the national interest. A, Central Bank is essentially a bankers' bank. Just as credit is given by the ordinary banks to a business man, the Central Bank gives credit to commercial banks by means of rediscounting facilities and its power of note-issue. It should conduct direct dealings with the public only in such forms and to such extent as, in the circumstances of the particular country, it considers absolutely necessary for the purpose of carrying out its monetary and banking policy. Since the central banks also distribute the total credit of the country among the several industrial and commercial institutions, it is essential that their business is conducted on safe lines. Their assets must be liquid and ungrudgingly placed at the disposal of approved banks. Their rights and privileges should also be properly defined and adequately protected by law.

The Functions of a Central Bank. In order to enable a Central Bank to achieve the above objects it is entrusted with the following functions :—

1. The Right of Note-issue ;
2. The Right to hold the Reserves of the Commercial Banks ;
3. The Right to Buy and Sell Securities ;
4. The Right to Discount.

The right of note-issue enables the bank to combine functions of currency and credit and thus to regulate the total amount of money in circulation. This is necessary for maintaining the stability of currency both inside and outside the country. As a custodian of the reserve of commercial banks, it can supervise and co-ordinate the activities of all banks in the country and ensure their co-operation at all times. The right to buy and sell securities facilitates open market operations, that is, enables it to expand the volume of currency in circulation by purchasing securities and to contract it by selling securities both to the public and to the member banks. At times credit restrictions are necessary to prevent excessive speculation and other unhealthy symptoms of trade or to correct adverse foreign exchanges. If commercial banks have huge cash resources the Central Bank may find it difficult to prevail upon them to restrict credit. Under such circumstances the Bank can reduce the market supplies of money by selling bills and securities on its own initiative in the open market until the discount rate becomes effective. Thus, with the diminution of the available cash supplies, a policy of credit restrictiou can be forced on the commercial banks. The bank can also purchase bills and securities which can increase the cash of the commercial banks and thus a sudden stringency can be relieved at the initiative of the Bank and credit expansion is possible. Open market operations also help the Bank in investing its funds remuneratively under appropriate conditions and safeguards. The control over the discount policy assists in regulating the amount of credit and in liquidating the assets of commercial banks. If a commercial bank is prudently managed and is sound, it can get loans from the Central Bank on approved short-term securities and can also get approved commercial paper rediscounted at the Bank. The grant of these facilities is a unique service rendered by Central Banks. The Central Bank's discount rate (or simply, Bank Rate) is also an effective means of stopping the outflow of gold from the country, for, by raising it the drawing of finance bills[1] of exchange is discouraged. Moreover, the sale of securities to the commercial banks can be enforced by means of the cash held by them at the Central Bank, and by reducing their cash balances with it the Central Bank can compel them to reduce their discounting business and thus to push up the discount rates. High rates of discount tend to curtail credit and *vice versa*. Hence, the normal working of a Central Bank brings about an evenness in monetary conditions.

Credit Control by Central Banks—Objects. From what has been said above it should be quite clear that the success of a

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[1] These are fictitious bills drawn against *blank credit*. They are drawn when the rates of interest in different countries are different and it is profitable to raise loans in one country for the purpose of investing them in the other. Also see Evitt—*A Manual of Foreign Exchange*, pp. 83-84.

The Bank Rate can be employed for checking gold exports in another way also. A rise in it lessens the demand for loans, checks expenditure in the country and lowers prices. This decreases imports and encourages exports and helps to restore the adverse trade balance which is the primary cause of the foreign demand for gold.

central bank depends upon its willingness and ability to control credit. What the immediate objective of credit control should be, however, is a very controversial question. Some people maintain that credit should be so controlled as to bring about stability of foreign exchange. Exchange stability, according to them, is of paramount importance for the maintenance of international confidence and the conduct of international trade on the largest possible scale which, in sum, is considered to be one of the prime requisites of the maximum economic welfare of the world. The believers in external stability of currency have often been in favour of specie standards, not only because the presence of precious metals inspires great confidence, but also because the free outflow and inflow of gold is supposed to be the best corrective of exchange disequilibrium. With the abandonment of the gold standard, this view became discredited, particularly because it was felt that the pursuit of exchange stability made a country dependent upon the currency and prices of other countries. People began to think more and more in terms of national welfare and of maintaining equitable relationship between the consumers and the producers, the employers and the employees and the creditors and debtors within the same country. Such people made stability of internal prices as the objective of their credit policy. But they soon found out that internal peace was not easy of attainment and, in any case, it could not be secured at the cost of foreign trade. Besides, the policy of stabilising internal price-level did not succeed in preventing booms and depressions. Hence, some economists began to lay greater emphasis on credit policy as a means of eliminating or smoothing out of the business cycles. In their opinion, attainment of the other two objectives, *viz.*, exchange and price stability, were highly desirable but only subsidiary to the maintenance of a normal and steady growth in general economic activity and, more particularly, to the prevention of economic crisis and unemployment.

In recent years, the tendency is to combine the objectives of international exchange stability with that of promoting and maintaining high levels of employment and real income or of maintaining an equilibrium between savings and investment at the point of full employment. The idea is embodied in the various international currency plans culminating in the International Monetary Fund which the United Nations have now set up. Several countries have also individually declared, in recent official documents, that the basic objective of their general economic policy will, in future, be that of maintaining full employment (United States and Australia), or a high and stable level of employment and income (Great Britain Canada, Sweden and South Africa) ; and that all available instruments of monetary, fiscal and other economic action will be applied towards the achievement of such objective.[1]

Methods of Credit Control. The chief methods or instru-

1 De Kock—*Central Banking*, p. 138. Also read Crowther, *An Outline of Money*. pp. 181-191.

ments which may be used by central banks for the control of credit, according to De Kock, are :—

1. The lowering or raising of their discount and interest rates with a view to lowering or raising money rates generally and encouraging the expansion or contraction of credit ;
2. The buying or selling of securities or bills of exchange in the open market with a view to putting additional funds into the market or withdrawing funds therefrom and thus expanding or contracting credit ;
3. The rationing of credit, as an alternative or an addition to raising discount and interest rates ;
4. The taking of "direct action" against those banks which borrow from the central bank for too long periods and in too large amounts, or which have been found to make undue use of central bank credit for financing speculation or non-essential industries or consumers' credit ;
5. The use of moral suasion and publicity ; and
6. The lowering or raising of minimum reserves to be kept by the commercial banks in the form of credit balances with the central bank as an additional means of enabling it, to expand or contract their credit-creating capacity.

In the United States, the central banking authorities have in recent years been empowered by law to employ two new methods of specialised credit control, namely, the regulation of margin requirements in connection with purchases of Stock Exchange securities, as an instrument of giving the Federal Reserve System some direct control over the volume of credit used in the security market ; and the regulation of the terms and conditions under which credit repayable in instalments may be extended for purchasing or carrying consumers' durable goods, as a means of exercising some direct control over the volume of outstanding consumer credit.[1]

Let us try to understand the working and efficacy of these systems, one by one.

Discount Rate Policy. It was used as the principal method of credit control under the gold standard. The underlying idea was that changes in the Discount Rate of the Central Bank would bring about more or less corresponding changes in local money rates generally and that such changes in money rates would, through their operation on the supply of and demand for money and credit and on the international flow of capital, have the effect of readjusting the domestic levels of prices, cost, production and trade and correcting any disequilibrium in the balance of payments. To be successful three conditions have to be satisfied, *viz* :—

(1) That the discount rate should have a prompt and decisive influence on money rates and credit conditions within its area of operation ;

1 *Op. cit.*, pp. 138-9.

(2) That there should be a substantial measure of elasticity in the economic structure in order that prices, wages, rents, production and trade might respond to changes in money rates ; and

(3) That the international flow of capital should not be hampered by any arbitrary restrictions.

In recent years the importance of the discount rate as an instrument of credit control has declined absolutely as well as relatively to other methods of control. This may be attributed, *firstly*, to radical changes in technical money market conditions and the economic structure[1] ; *secondly*, to the increased use of other methods of credit control because of their greater directness and adaptability under certain circumstances ; and *thirdly*, to the maintenance of cheap money as a matter of public policy or to the existence of liquid monetary conditions on account of other factors. Among other factors responsible for the decreasing importance of discount rate may be mentioned the institution of managed currency systems in different countries and the emergence of planned economy. The more an economy is regulated in prices, wages, transportation charges and the more the Government extends its influence over business, the more the influence of interest declines.

Hence, we may conclude with De Kock, "While it is obvious that, under present-day conditions of economic rigidity and complexity, as well as monetary liquidity, there is much less scope for an effective discount-rate policy than was formerly the case, the discount rate of the central bank has nevertheless a useful function to perform in certain circumstances and in conjunction with other measures of control. With the re-establishment of an international monetary system and the ultimate obligation of member countries to maintain exchange stability and free inconvertibility of their currencies at least for all current exchange transactions, changes in discount and interest rates will probably again have to be employed as a necessary instrument contributing towards the restoration of equilibrium, since they operate in various ways to correct wrong trends, namely, through their influence on the supply of and demand for money and credit, or on the rate of investment and speculation, or on human psychology in general."[2]

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1 As for instance, in England the use of bills of exchanges as a basis for financing domestic trade has shown a considerable decline as against the system of bank overdrafts. The influence of Treasury Bills on the money market is greater than those of the bills of exchange and the relative position between London and other money markets has changed considerably since World War II. Moreover, the political, monetary and economic complications in various countries, and frequently also exchange control, dislocated the international flow of capital and increased the rigidity in the structure and functions of the capital market in most countries.

2 *Op. cit.*, p. 189.

Also read Keynes's *Treatise on Money*, Vol. I, pp. 186-220, Hawtrey's *Capital and Employment*, pp. 2-4 and *A Century of Bank Rate* by the same author.

Open Market Operations. In the event of the failure of discount policy, the central bank goes into the open market to buy and sell securities.[1] When securities are bought in the open market, the reserves of the commercial banks with the central bank are increased. What usually happens is that the central bank pays by a cheque drawn on it and the seller of the securities deposits the cheque with one of the member banks whose reserves with the central bank are thus increased. Member banks regard their reserves with the central bank as equivalent to cash and consequently adopt a liberal loan policy which results in the lowering of rates and expansion of credit. Conversely, the selling of securities in the open market by the central bank will reduce the deposits of the member banks who will thus be compelled to adopt a more conservative policy leading to contraction in credit.

Open market operations represent a more direct as well as a more comprehensive instrument of credit control, provided there are broad and active markets in the types of short and long-term securities in which the central bank can legitimately deal and that such securities constitute a sufficiently sensitive and decisive part of the whole capital or credit structure. The extent of success will depend upon the following factors :—

(1) Whether the cash reserves of the commercial banks increase or decrease in accordance with the nature and extent of the central bank's open market operations ;

(2) Whether commercial banks expand or contract credit in accordance with the increase or decrease in their cash reserves ;

(3) Whether the changes in the demand for bank credit accord with changes in the reserves of the commercial banks and discount rates ; and

(4) Whether velocity of circulation of bank deposits remains the same or not.

In actual practice, sometimes the quantity of money in circulation and the cash reserves of the commercial banks do not increase or decrease even approximately in proportion to the purchase and sale of securities by the central bank. Moreover, the commercial banks do not always increase or decrease their loans, discounts and investments in accordance with the increase or decrease in their cash reserves. There is also, sometimes, lack of willing and deserving borrowers. In times of economic and political uncertainty, entrepreneurs may not be prepared to undertake great risks even if their bankers offered them increased accommodation at moderate rates. Sometimes it is not only a case of unwillingness to borrow on the part of entrepreneurs but also of unwillingness to lend on the part of

1 *I.e.*, any kind of paper in which it deals, whether Government securities or other securities or banking acceptance or foreign exchange generally.

banks. Further, the circulation of money and credit does not have a constant velocity, nor is this velocity always directly controllable as it is the resultant of human reactions.

On the whole, it must be admitted that conditions necessary for the completion of open market are generally fulfilled. In fact, owing to the ineffectiveness of the discount rate on the one hand and the growing volume of Government securities and of the increased dependence of Governments on central banks for meeting their financial requirements on the other, open market operations as a method of credit control has assumed great importance nowadays.

Rationing of Credit. Under a system of planned economy the central bank may allot funds to different enterprises as contemplated in the plan. Even in capitalistic states with free enterprise, the central bank may put a limit to its discount operations, or when the demand for credit exceeds the supply that can be safely made, it may allocate funds in a certain proportion. There is, however, a danger that the rationing may not be satisfactory and that the central bank may abuse its power by giving preferential treatment to favoured customers. Hence it can be justified only as a temporary expedient or an abnormal measure dictated by special circumstances or as part of a comprehensive scheme of national economic planning.

Direct Action. If commercial banks persist in pursuing a policy which conflicts with the declared policy of the central bank, the latter may be compelled to take "direct" or "coercive" action against the former. Direct action may take either or all of the following forms :—

(1) Refusal on the part of the central bank to rediscount for banks whose credit policy is regarded as being inconsistent with the maintenance of sound credit conditions ;

(2) Refusal to grant further rediscounts to banks whose borrowings from tbe central bank are considered to be excessive in relation to their capital and reserves or to their proportionate share of the resources of the central bank ;

(3) Charging penalty rates, over and above the official discount rates, from the offending banks.

In many cases direct action has not been found to be very satisfactory, partly because the element of force associated with it is not generally conducive to the attainment of positive results and partly because commercial banks themselves find it very difficult to control the ultimate use of credit and to make clear-cut distinctions in all cases between legitimate and purely speculative activities. Moreover, it is difficult to reconcile direct action, in the form of refusal to rediscount, with the central bank's function as a lender of last resort and it can be applied only if the offending banks are short of funds and cannot replenish their reserves from outside sources.

Moral Suasion. Compulsion may often be inexpedient. In such cases the central bank endeavours to achieve its object by making suitable representation to the institutions concerned and relying on its moral influence and power of persuasion. Some people hold the view that mere moral suasion is not likely to carry any weight with the commercial banks but upon expanding credit. It has at least the advantage of creating a less unfavourable psychological reaction since it is not accompanied by statutory or administrative compulsion or threats of punitive action. The use of moral suasion makes it eaiser for the central bank to secure the willing and active co-operation of the commercial banks in the spirit as well as the letter ; and without such co-operation the central bank cannot hope to achieve tangible results in thc long run in the direction of qualitative control of credit. "To sum up, therefore, while there is scope for the useful application by central banks of direct action and moral suasion, their limitations in various directions must be fully recognised. Direct action should on the whole be confined to special cases, particularly in democratic countries, although it might, like rationing of credit, fit in fairly well with the conditions prevailing in authoritarian states. For moral suasion there is in general a wider scope than for direct action, and in countries where there are highly liquid monetary conditions and where the central bank either cannot undertake open market operations at all or cannot do so on a scale sufficient to counteract the undue liquidity, it is advisable if not essential for the central bank to use moral suasion as far as possible, in spite of its limitations. Its success would depend largely on the prestige and personal authority of the central bank ; the technical means and statutory powers at the disposal of the central bank ; the degree of co-operation between the central bank and the commercial banks as well as other financial institutions ; and the make-up of the country's banking and credit structure."[1]

Changes in the Minimum Cash Reserves of Commercial Banks. A typically American system, it is now very widely used. The central bank is given power to increase or decrease the minimum cash reserves to be kept with the central bank by the commercial banks.

It suffers from the disavantage that when reserve requirements are increased, some banks will be hit much harder than others. Moreover, as in the case of open market operations, changes in reserve requirements have the effect of increasing or decreasing the available supply of bank cash which need not necessarily be accompanied by corresponding changes in the value of credit actually created. Moreover, since changes in reserve requirements affect the credit-creating capacity of all commercial banks and represents a powerful force to do good or harm to the banks and the community as a whole, the power to make changes throws an enormous responsibility on the central bank.

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1 De Kock—*Central Banking*, p. 244.

"In short, while it is a very prompt and effective method of bringing about the desired changes in the available supply of bank cash, it has some technical and psychological limitations which prescribe that it should be used with moderation and discretion and only under obviously abnormal conditions."[1]

This method should be widely employed either as an alternative to open market operations or as a supplement to them under conditions of severe credit stringency.

Changes in the Margin Requirements on Security Loan. Another exclusively American system, it is specially intended to help the central bank in controlling the volume of credit used for speculation in securities. Under the Securities Exchange Act of 1934, the Board of Governors of the Federal Reserve Bank have been empowered to prescribe rules with respect to the amount of credit that can be extended by banks against securities registered on national seeurity exchanges for the purpose of trading in such securities and with respect to margins for loans by brokers to their customers.

Regulation of Consumer Credit. Originally adopted by the U.S.A. as a defence measure, it has now developed into a useful method of controlling credit. Under an Executive order issued in 1941, the Board of Governors is authorised to regulate the terms and conditions under which credit repayable in instalments may be extended for purchasing or carrying consumers' durable goods such as automobiles, motor cycles, refrigerators, sewing machines, radio sets, etc. It should be tried by other countries, especially those where extensive use is made of consumer instalment credit owing to the relationship of such credit to cyclic fluctuations in general business.

Publicity. Another typically American practice, it is now followed by many other countries as well. It enjoins upon the central bank to publish weekly statements of its assets and liabilities, monthly reviews and credit and business conditions and comprehensive annual reports on their own operations and the activities of the money market and dealing with problems of public finance, trade, industry and agriculture, etc. "Owing to the increasing public interest and intervention in matters of monetary and banking policy, some publicity by the central bank appears to be essential. In general, it may be regarded as another instrument which is to be used with moderation and discretion."[2]

Such institutions exist in almost every civilised country of the world—Bank of England in England, Bank of France in France, Reichs Bank in Germany and the twelve Federal Reserve Banks operating under the Federal Reserve Board of Washington. Even in India the amalgamation of the three Presidency Banks showed clearly that the people were no longer afraid to "put all their eggs in

1 De Kock—*Central Banking*, pp. 250-51.
2 *Ibid.*, p. 255.

the same basket." Unluckily for India, the Imperial Bank was deprived of the power of note-issue which is the *sine qua non* of a modern Bankers' Bank, and by its own sins of omission and commission, it failed to inspire sufficient confidence to be reckoned as such.

The Government introduced the Gold Standard and Reserve Bank of India Bills in the Assembly in 1927 and 1928. The former was approved but the latter raised a tremendous issue over which the whole scheme foundered.

A State or Share-holders' Bank. In determining the constitution of the Reserve Bank, opinions were divided as to whether it should be managed and owned by the State or it should be floated with the help of capital raised from private share-holders. Those who favoured the State control of the Bank urged that since a wise central banking policy is the basis of a sound national economic life, the central bank should be under the control of the Government. Especially in India, which is noted for mass illiteracy and absence of banking habits, only a State bank can inspire confidence among the people, much more so if it is made responsible to the Legislature. In case of extreme national emergency, the State can command greater purchasing power through the expansion of specie payments only if it has an effective control over the administration of the bank. They also argued that a central bank does not require much capital nor a large body of profiteering share-holders. It can, therefore, be freed from the domination of large capitalists in big cities and prevented from degenerating into a dividend-hunting organisation only by transferring control to the State.

Those who favoured the share-holders plan, on the other hand, maintained that if the management of note-issue is entrusted to the State itself the Government may be tempted to adopt the simple method of raising money which is offered by the power of printing notes. Besides, monetary policy should be independent of political contingencies and the surest way of securing this result is to place the control of note-issue in the hands of a bank. They also contended that if the bank is under State control, continuity of policy cannot be guaranteed with changing governments nor can freedom from political bias in its administration be assured.[1] The network of financial and commercial life is so intricate and the decisions of the bank on important points have such widespread results that all interests are not affected in the same way. If, therefore, there is an independent or quasi-independent bank, the Government

1 "The cases of the Bank of Spain in the latter part of the 19th century and of the Bank of France in recent years can be cited to prove the point. In both cases the banks acting under Government compulsion exceeded legal limits for advances to the Treasury with the result that the currency depreciated heavily. The financial crisis in France in 1926 was intensified by the depreciation of the franc which was caused by exceeding the legal limit from 41 milliard francs fixed in 1920 to over 3,000 million francs, with the result that the volume of notes in circulation rose to over 43 milliard francs."—Hon. G. Pal, *The Financial Crisis of France*, pp. 230-32.

would find it difficult in practice to suspend the obligation of the bank except when a true national emergency occurs.

Bearing these facts in mind one is not surprised to learn that even among the recently established or recently reorganised banks there is already a tendency to move away from complete State control. A resolution of the Brussels Conference emphasising that "banks, and especially a Bank of Issue should be freed from political pressure and should be conducted solely on the lines of prudent finance" crystallizes the general feeling on the point. The statutes of the central banks set up or reorganised during the post-war reconstruction period generally contain a clause or a sentence emphasising this independence either as regards ownership or management, but more especially the latter, a notable exception being the statutes of the Bank of Finland. The latter were modelled on the statutes of the Swedish Riksbank and the Bank of Norway and provide for fairly close State supervision and control and for important appointments at the bank being made by public authorities. A State should be capable of carrying out its task efficiently if the Government and Legislature impose upon themselves a self-denying ordinance limiting their opportunities for intervention but, owing to the inherent weakness of human nature and due to the suspicion, with which all State activities are regarded in India, a State Bank does not appear to be advisable.[1] This, however, does not rule out the desirability of general superintendence. Governments in most countries have some influence in the matter of the constitution of the governing body of the central banks and exercise the right of general supervision and control in the interest of the public.

The Banking Enquiry Committee. Being unable to come to an agreement, the Government postponed the question *sine die* and in the meanwhile ordered a comprehensive banking enquiry for the whole of India in 1929 with the following terms of reference :—

> "To investigate past records and existing condition of banking in India, including the organisation of the Money Market, and to consider the steps, if any, that are feasible and desirable

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1 "Almost all the Central Banks of the world have been set up on the basis of privately supplied capital and under the management of a Board of Directors who, in their daily administration, are protected against interference on the part of the Government or Legislature. The choice of Governors and Deputy Governors is subject to official approval so that the State as representing the public may have assurance that the highest administrative offices are properly filled."—Sir Cecil Kisch "Empire Central Banks" in the *Indian Finance Reserve Bank Inauguration Number.*

In recent years, the State has assumed partly or wholly the ownership of the central bank in other countries—Canada, Denmark, Italy and New Zealand. The capital of the central bank is owned by the State also in Australia, Finland, Latvia and Sweden. In other countries the law provides that the State may hold a stated proportion of the central bank's capital, *e.g.*, in Czechoslovakia a third, in Japan half and in Rumania 10 per cent.—League of Nations—*Monetary Review*, 1937-38, pp. 81.

under the following main headings :—

(*a*) The development of banking with a view to the expansion of indigenous, co-operative and joint-stock banking with special reference to the needs of agriculture, commerce and industry ;

(*b*) The regulation of banking with a view to protecting the interests of the public ; and

(*c*) Banking education with a view to the provision of Indian personnel in adequate numbers and with the necessary qualifications to meet the increasing needs of the country for a sound and well-managed national system of banking."

The Native States were also invited to undertake similar enquiries in their respective territories. The principal recommendations of the Central Banking Enquiry Committee may be briefly summarised as follows :—

1. The establishment of a Central or Reserve Bank for the mobilisation of the banking and currency reserve of India and for increasing the volume of credit available for trade, industry and agriculture.

2. The removal of the restrictions on the foreign exchange business of the Imperial Bank of India as being in the interest of development of India's foreign trade. The creation of a new Exchange Bank in the event of no satisfactory arrangement being made between the proposed Reserve Bank and the Imperial Bank of India regarding the conduct of exchange business if the latter should find itself unable to fulfil its obligations regarding foreign trade within a stipulated period. For the development of the Indian bill market, the Reserve Bank is to be permitted to purchase, sell and rediscount rupee import bills. The formation of an All-India Bankers' Association including as members, not only the three classes of Banks, but indigenous banks as well.

3. For the regulation of banking, two principal recommendations are made : (*a*) The promulgation of a special Bank Act comprising provisions governing all banking institutions, and (*b*) the amendment and amplification of the Indian Companies Act so as to provide for additional matters which require to be dealt with by legislation.

4. For the development of banking education, the universities are urged to give greater facilities for the study of banking.

A Bill was accordingly introduced in the Legislative Assembly which after drastic modifications passed it into law in 1934.

Summary of the Reserve Bank of India Act of 1934. The Act provides for the establishment of a Bank—to be called the Reserve Bank of India—for the purpose of taking over the management of the currency from the Governor-General-in-Council and of carrying on the business of banking as specified in the Act.

Share Capital, Share Register and Share-holders. The original share capital of the Bank shall be five crores of rupees divided into fully paid-up shares of one hundred each. Separate registers of share-holders shall be maintained at Bombay, Calcutta, Delhi, Madras and Rangoon and a separate issue of shares shall be made in each of the areas served by those registers. A share-holder shall be qualified to be registered as such in any area in which he is ordinarily resident provided he is domiciled in India and, in the case of a company, provided it is registered in India under the Indian Companies Act, 1913, or under the Co-operative Societies Act, 1912.

Management. The general superintendence and direction of the affairs and business of the Bank shall be entrusted to a Central Board of Directors which shall consist of (*a*) a Governor and two Deputy Governors to be appointed by the Governor-General-in-Council on the recommendations of the Board, (*b*) four directors to be nominated by the Governor-General-in-Council, (*c*) eight directors to be elected on behalf of the share-holders on the various registers, and (*d*) one Government official to be nominated by the Governor-General-in-Council who may attend any meeting of the Board and take part in its deliberations but who shall not be entitled to vote. The Governor and Deputy Governors shall be whole-time paid servants and shall hold office for such term, not exceeding five years, as the Governor-General-in-Council may fix and shall be eligible for reappointment. Meetings of the Central Board shall be convened by the Governor at least six times in each year and at least once in each quarter.

There shall be a Local Board for each of the five areas for advising the Central Board on such matters as may be generally or specifically referred to it or to perform such duties as may be delegated by the Central Board. Every Local Board shall consist of (*a*) five members elected from amongst themselves by the share-holders of each area, and (*b*) not more than three members nominated by the Central Board from amongst share-holders of the area, due regard being paid to the representation of share-holders of that area and to the representation of territorial and economic interests—especially the agricultural interests, and those of co-operative banks. At an election of members of a Local Board for any area, any share-holder who has been registered on the register of that area for a period of not less than six months ending with the date of election as holding five shares shall have one vote and each share-holder so registered as having more than five shares shall have one vote for each five shares but subject to a maximum of ten votes. Salaried Government officials, members of the Assembly and Legislative Councils, officers and employees of other banks and insolvents and lunatics are debarred from being directors or members of Local Boards.

Business which the Bank may transact. The Bank shall be authorised to transact and carry on the following kinds of business :—

(1) To accept money on deposit without interest from the

Government, Native States, local bodies, banks and other persons.

(2) To purchase, sell and rediscount bills of exchange and promissory notes drawn on and payable in India and arising out of *bona fide* commercial or trade transactions bearing two or more good signatures one of which shall be that of a scheduled bank[1] and maturing within ninety days from the date of such purchase or rediscount, exclusive of days of grace. The Bank is also authorised to purchase, sell and re-discount bills drawn or issued for the purpose of financing seasonal agricultural operations or the marketing of crops maturing within nine months and those issued and drawn for the purpose of holding or trading in securities of the Government of India or a Local Government and maturing within ninety days from the date of such purchase or discount, exclusive of days of grace.

(3) (*a*) To purchase from and sell to scheduled banks sterling in amounts of not less than the equivalent of one lakh of rupees;

(*b*) to purchase, sell and rediscount bills of exchange (including treasury bills) drawn in or on any place in the United Kingdom and maturing within ninety days from the date of purchase, provided that no such purchase, sale or re-discount shall be made in India except with a scheduled bank; and

(*c*) to keep balances with banks in the United Kingdom.

(4) To give loans and advances to Native States, local bodies, banks and co-operative societies repayable on demand or on the expiry of fixed periods, not exceeding ninety days, against approved securities.

(5) To make to the Governor-General-in-Council and Local Government advances repayable not later than three months from the date of making the advance.

(6) To purchase and sell Government securities of the United Kingdom maturing within ten years of such purchase and other securities of the Government of India and Local Governments, provided that the total amount of such securities held at any time in the Banking Department does not exceed the aggregate amount of share capital of the

1 Approved banks mentioned in the Second Schedule appended to the Act. Such banks have a minimum capital of Rs. 5 lakhs and are required under Section 42 of the Reserve Bank of India Act to maintain deposits with the Reserve Bank. Section 18 also authorises the Bank to purchase, sell and discount bills of exchange and promissory notes which do not bear the signature of a scheduled bank or a co-operative bank for the purpose of regulating credit in the interest of Indian trade, commerce, industry and agriculture.

Bank, the Reserve Fund, and three-fifths of the liabilities of the Banking Department in respect of deposits.

(7) Custody of monies, securities and other articles of value and the collection of interest and dividend on such securities.

(8) To sell and realise all property whether movable or immovable which may in any way come into the possession of the Bank in satisfaction of any one of its claims.

(9) To act as agent for the Secretary of State, the Governor-General-in-Council or any Local Government or State in India for the purchase, sale and custody of gold and silver, bills of exchange and securities of shares in any company for collection of interest on securities and shares, for the remittance of such proceeds by bills of exchange payable either in India or elsewhere and the management of Public Debt.

(10) To purchase and sell gold coin and bullion.

(11) To open an account with or to make an agency agreement with the Central Bank of any other country.

(12) To borrow money for a period not exceeding one month for the purpose of the business of the bank from a scheduled bank or from the Central Bank of any other country provided that the total amounts of such borrowings from persons in India shall not, at any time, exceed the amount of the share capital of the Bank.

(13) To make and issue Bank notes.

(14) An Ordinance passed in July 1949 authorised the Bank to undertake the issue and management of the bonds and debentures of the Industrial Finance Corporation. The position has been made permanent by an amendment which has been recently made to the Reserve Bank of India Act.

Business which the Bank may not transact. The Bank is not allowed to :

(*i*) Engage in trade or to have a direct interest in any commercial or industrial undertaking.

(*ii*) Purchase its own shares or the shares of any bank or of any company or grant loans upon the security of any such shares.

(*iii*) Advance money on mortgage of immovable property.

(*iv*) Make loans or advances.

(*v*) Draw or accept bills payable otherwise than on demand.

(*vi*) Allow interest on deposits or current accounts.

Issue of Rupee Coin and Sale and Purchase of Sterling. The Government shall cease to issue rupee coin except through the Bank. The

bank shall also sell sterling in India for immediate delivery in London at a rate not below 1s. 5·49/64d. for a rupee provided that no person shall be entitled to demand an amount of sterling less than ten thousand pounds. Similarly, the bank shall buy sterling in India for immediate delivery in London at a rate not higher than 1s. 6·3/16d. for a rupee.

Relation with Scheduled Banks. The conditions which a bank must fulfil in order to be classed as a scheduled bank are laid down in Section 42 (6) of the Reserve Bank Act, namely :—

(*a*) it should have a paid-up capital and reserves of an aggregate value of not less than Rs. 5 lakhs ; and

(*b*) it should be a company as defined in Clause (2) of Section 2 of the Indian Companies Act, 1913, or a corporation or company incorporated by law outside British India.

"The aggregate value of the paid-up capital and reserve" means the real or exchangeable value of these and not merely the book value as shown in the balance-sheet.

The inclusion of a bank in the schedule gives no continuing guarantees of its soundness or stability ; its fitness to be retained in schedule is liable to be tested, if desired, by Government.

Every scheduled bank shall maintain with the Reserve Bank a balance the amount of which shall not, at the close of business on any day, be less than five per cent of the demand liabilities and two per cent of the time liabilities of such bank in India. For this purpose liabilities shall not include the paid-up capital or the reserves or any credit balance in the profit and loss account of the bank or the amount of any loan taken from the Reserve Bank. If the balance held at the Bank by any scheduled bank is below the prescribed minimum, the defaulter will be liable to pay to the Bank in respect of each such day penal interest at a rate of three per cent above the Bank Rate on the amount by which the balance with the Bank falls short of the prescribed minimum.

The real purpose of these balances is not to guarantee the deposits of the public with banks but to enable the Central Bank to exercise more measure of control over the banking system as such.

Every scheduled bank has to send to the Central Government and the Reserve Bank a weekly return of its position in the form prescribed in Section 42, Clause (2) of the Act. In one or two cases monthly returns are allowed. The Reserve Bank prepares and publishes a consolidated statement of these returns every week. A scheduled bank failing to submit the weekly or monthly return of its position is liable to pay to the Central Government or to the bank, as the case may be, or to each, a penalty of one hundred rupees for each day of default.

The most important facility which the scheduled banks enjoy is that of financial accommodation in the shape of rediscount of eligible bills or loans and advances against eligible securities from the Reserve

Bank. According to Section 7 of the Act, the Reserve Bank may call for necessary information from the borrowing scheduled bank.

Allocation of Surplus. After paying out of the net annual profits dividend at a rate not exceeding five per cent, a small proportion of the surplus shall be allocated to the payment of an additional dividend to the share-holders and the balance of the surplus shall be paid to the Governor-General-in Council.

Agricultural Credit Department. The Bank will establish a special Agricultural Credit Department the function of which will be to maintain an expert staff to study all questions of agricultural credit and to co-ordinate the operations of the Bank in connection with agricultural credit with Provincial Co-operative Banks and other banks or organisations engaged in the business of agricultural credit.

Exemption of the Bank from Income-tax and Super-tax. The Bank shall not be liable to pay income-tax or super-tax on any of its incomes, profits or gains but the liability of share-holders in respect of income-tax or super-tax shall remain unaffected.

Publication of the Bank Rate. The Bank shall publish, from time to time, the standard rate at which it is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under the Act.

The Bank will also publish the accounts of both the Issue and Banking Departments weekly in the Gazette of India.

The Reserve Bank of India Act was passed in March, 1934, and the Bank began to function from April 1st, 1935. From this date the Reserve Bank took over the management of the Currency Department of the Government of India by the creation of a special department called the Issue Department. The assets of the Gold Standard Reserve were transferred to the Bank and were combined with the assets of the Currency Department. The Bank also took over the duty of supplying the Secretary of State with sterling for his London requirements and of maintaining Government balances which were transferred to it by the Imperial Bank—the Imperial Bank being retained at its agent at places at which the Reserve Bank had no office of its own. From July 1st, 1935, the Banking Department was opened and the scheduled banks deposited the required percentage of their demand and time liabilities. The Clearing House was transferred from the Imperial Bank to the Reserve Bank as from this date. In January, 1938, the Reserve Bank issued its own notes of the denominations of Rs. 5 and Rs. 10. This was followed later during the year by the issue of Bank notes of the denominations of Rs. 100, Rs. 1,000 and Rs. 10,000. The Bank had also issued Burma bank notes in new designs of denominations similar to those in use in India.

Advantages Expected from the Reserve Bank. It will be observed that the Act is based on the recognition of the fact that the Reserve Bank should control, but not compete with the commercial banks. This was particularly desirable in view of the fact that the Reserve Bank has been allowed free use of Government balances and

might easily forfeit the confidence and support of other banks by taking undue advantage of this privilege. To ensure control, it has been laid down that all the member banks must keep a fixed percentage of their current and time deposits—5 per cent and 2 per cent respectively—with the Reserve Bank. To prevent competition with the commercial banks, several provisions have been laid down, the most important of them being that the Reserve Bank can only take in deposits free of interest, that it cannot grant advances directly to the public, and that it cannot purchase or discount paper unless it bears the signature of a member bank except in very special circumstances for which provision has been made in Section 18 of the Act. To give it full control over credit and currency, the Bank has been entrusted with the monopoly of note-issue as well as the power of holding reserves against notes. The power to hold the cash balances of the commercial banks as well as the privilege of holding Government balances also provide useful means to the Bank for exercising its influence over the credit situation. The Reserve Bank will be able to regulate the amount of seasonal currency through its control over the Bank Rate and through open market operations which have been authorised by the Act. The Bank will be able to mobilise the capital resources which are lying about in pools scattered all over the country in the form of hoards. By acting as a Clearing House for member banks, it will prevent a large quantity of cash from moving to and from and in a circumlocutory manner between bank and bank. It will also promote habits of banking and investment both directly and by expanding productive activity within the country and thus holding out chances of reaping good profits from new enterprises. The power to deal in foreign exchanges will enable it to reduce exchange fluctuations to the minimum and thus to promote the stability of business and exchange. By coming into contact with the central banks of other countries it would promote central banking co-operation which is so essential for securing monetary rationalisation and comparative standardisation of world prices. The present economic ills of the world are largely the result of currency and monetary disturbances and the situation can be changed for the better only if the central banks, backed up by the respective governments of their countries, show a spirit of harmonious co-operation.[1] In short, it is hoped that the Reserve Bank, which started functioning since April, 1935, will remove most of the glaring defects of the Indian Money Market and afford much-needed relief to trade and industry and more particularly to agriculture which is the largest single industry of our country. It will watch the progress of banking in the country and direct it on the right lines and in the interest of the nation as a whole.

Rural Finance. The activities of the principal rural credit agencies, *viz.*, the indigenous bankers, the co-operative societies, and

1 That this spirit is for the moment lacking is proved by the failure of the World Economic Conference which had raised high expectations in the minds of people all over the world.

the Land Mortgage Banks, have already been discussed. It now remains for us to see how far the Reserve Bank can help the extension of credit facilities in the rural areas. But before doing so we shall point out the distinguishing features of agricultural finance.

Peculiarities of Rural Finance. The Indian cultivator, as we all know, is usually steeped in debt. He uses little discretion in the matter of selecting his cattle and implements, and perhaps none in the disposal of his produce. His credit needs are satisfied inadequately and at ruinous prices. But agriculture should be a productive and a profitable industry. Why should the cultivator find it difficult to raise necessary credit when traders and manufacturers are able to do so without any difficulty? The answer is simple enough. In the first place, the agriculturist borrows money on the security of one man, or at the most one family, and the method of raising capital by subscription of shares employed by the joint-stock companies is not open to him. Secondly, the long-term loans are usually raised against the security of land, but land is a most unsuitable form of security because it is not a readily realisable asset and its price is liable to frequent changes. There may also be difficulties in connection with title and customary or statutory restrictions on the right of transfer. Thirdly, while other industries tend to become concentrated in units of ever-expanding size, agriculture remains scattered, individualistic, small-scale and chaotic. Hence, the farmer remains dependent upon his own resources, and the savings of the community in general are relatively inaccessible to him. Fourthly, agriculture is a very uncertain industry. The capital of the farmer is for the greater part of the year sunk in the forms of wealth which none but an expert can value on the basis of the probability of a successful yield of crops and which, therefore, cannot be regarded as good security for an advance. His own illiteracy and ignorance reduce his credit-worthiness to the very minimum. Fifthly, the agriculturist cannot easily adjust the supply of his produce to demand. He cannot abandon his land even when the demand for produce goes down. Hence loans taken at a time when prices are uneconomic often hang like a millstone round his neck especially if the cultivator is also ignorant of the two cardinal points of farming, *viz.*, what farming costs and what it brings him.

The problem of establishing a satisfactory link between the agricultural industry and the money market *i.e.*, between the farmer seeking credit and the capital seeking investment has not been satisfactorily solved in any country of the world. The ordinary commercial banks can only afford to lend money for short periods and expect the loans to be repaid punctually when they fall due. The agriculturist, however, cannot satisfy these conditions. His repaying capacity is conditioned by uncertainties of season and in the event of famines and floods the redemption of the loan must be postponed until the return of better conditions and must eventually be made in small instalments spread over a number of years. "The rapid circulation of money being essential to the success of a commercial

bank and the bulk of its working capital being derived from short-term deposits or call money, a commercial bank cannot, generally speaking, afford to postpone its recoveries or tie up its resources to accommodate the farmer's needs." It is, therefore, clear that in the present state of our agriculture, there cannot be any direct contact between the commercial banks and the cultivator. Some intermediates like the money-lenders or the co-operative societies are quite unavoidable and their resources can be mobilised and their activities properly co-ordinated in the interest of rural finance only through contacts which may be established between them and the central bank of the country.

Reserve Bank and Agriculture. Accordingly, the Reserve Bank Act has imposed certain obligations upon the Reserve Bank according to which it can place its resources at the disposal of the agriculturist without violating the essential principles of central banking. For instance, while bills and promissory notes against which the funds of the Reserve Bank may be obtained must relate to short-term needs, *i.e.*, the financing of seasonal agricultural operations or the marketing of crops only, the maturity of such bills and notes is extended as a special case to a maximum of nine months. This period was subsequently raised to 15 months. Moreover, while the principle that the funds of the Reserve Bank can be available only for the relief of exceptional pressure on the resources of intermediary banks is strictly adhered to, the endorsement of the Provincial Co-operative Banks is given as a special case the same status as the endorsement of a scheduled bank for the purpose of purchase, sale or rediscount of these bills. As for loans and advances, the Provincial Co-operative Banks can obtain them from the Reserve Bank, *i.e.*, for a minimum period of 90 days and against Government securities, agricultural paper and document of title to goods. According to another amendment made in the Act in 1953, the Reserve Bank is permitted to make medium-term loans against securities specified by it for agricultural purposes subject to the following four conditions :—

(1) The period for which loans are granted should not be less than 15 months but not exceeding five years ;

(2) The loans are to be fully guaranteed by the State Governments as regards both principal and interest ;

(3) Each State Co-operative Bank is entitled to let loans not exceeding its own funds ; and

(4) The total amount of loans to be made available must be Rs. 4 crores in all.

The purposes for which loans will be granted include, for the present, reclamation of land, bunding and other land improvements, preparation of land for orchards and plantations, minor irrigation works, purchase of livestock, machinery and equipment, construction of farm houses and cattle sheds etc. As in the case of short-term loans which mature within 15 months, the Reserve Bank will charge the same concessional rate of interest, namely, 2 per cent below the

Bank Rate which is now 3½ per cent. The State Co-operative Banks will thus be able to obtain medium-term advances from the Reserve Bank at 1½ per cent.

The Bank can help agriculture in many other ways. For instance, warehouses controlled by the bank can be very useful to co-operative sale societies for stocking agricultural produce and getting prompt and cheap credit against it. Similarly the Bank can render valuable help to the land mortgage banks in floating debentures and in arranging cheap long-term loans.

Agricultural Credit Department. The Reserve Bank has also set up a separate agricultural Credit Department the functions of which are (*a*) to maintain an expert staff to study all questions of agricultural credit and be available for consultation to all banking organisations, and (*b*) to co-ordinate the operations of the Bank in connection with agricultural credit and its relations with Provincial Co-operative Banks and any other bank or organisation engaged in the business of agricultural credit.

The Bank was also required to make a report to the Governor-General-in-Council, at the earliest possible time and in any case within three years of its establishment on two specific points, *viz.*, (*a*) the extension of Reserve Bank facilities to persons and firms who did not fall in the category of scheduled banks (money-lenders and co-operative societies) ; and (*b*) the improvement of methods for effecting a closer connection between agricultural enterprise and the operations of the Bank.

The report was issued in due course and has been supplemented by several bulletins containing the views of the Reserve Bank on the whole question of agricultural credit and indigenous banking. It points out the difficulties we have already noted about the inclusion of money-lenders and indigenous bankers within the organised banking structure of the country, particularly their unwillingness to shed non-banking business and adoption of modern accounting and banking practices. In regard to the co-operative movement, it has made out a strong case for reconstruction of the whole structure. "While overdues are scaled down and passed on to long-term credit institutions and co-operative credit societies restrict themselves in future to crop loans repayable out of the harvest or intermediate credit in a limited measure, an endeavour should be made to enlarge the functions of these societies so that they cover the whole life of the farmer, *i.e.*, become multi-purpose societies. The financing agency is to consist of two stages : banking unions for small areas with a radius of 7 to 8 miles, and Provincial Co-operative Banks. Strict observance of business and banking principles, highly trained staff, etc., are other directions in which improvement is urgently necessary."[1]

In a circular dated June 12, 1939, the Reserve Bank has refused to recognise any difference between commercial banks and

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1 Muranjan, *Modern Banking in India*, pp. 282-283.

co-operative banks from the banking point of view except that the former cater for the needs of the trade and industry while the latter primarily finance agriculture and has emphasised that the same conditions of safety and liquidity in the employment of funds are essential for the stability of both. The Bank has further stressed the necessity of stating overdues clearly and separately in the balance-sheets, separating long-period from short-period loans to the maximum of an amount equal to the paid-up capital and reserves doing away with the practice of fictitious repayments which conceal the position not only from outsiders but also from those who are in authority over the bank and building up strong reserve funds.

Extension of Banking Facilities to Rural Areas. Since World War II the saving capacity of the nation has shifted in a substantial measure from the upper and middle classes to the industrial workers and the farmers. The farmers are now in a position to make some savings because the prices which they can secure for their produce are very much higher than the prices which they have to pay for the goods they purchase for their production as well as consumption. Unfortunately the farmers have not yet formed the habit for saving. Propaganda conducted by the Government to induce them to form this habit by purchasing National Savings Certificates has had little effect so far and the only way to tap rural savings seems to be to establish branches of joint-stock commercial banks in rural areas. On account of continued shrinkage in business and increased working expenses, many banks may not be persuaded to open branches in rural areas unless such branches are exempted from the operation of the Industrial Disputes Act. Help from the Government in the form of interest-free loans, use of Government buildings, cheap remittance facilities etc., would enable rural branches to stand on their own legs and to develop the saving and banking habits among the rural classes. It has also been suggested that in rural areas, instead of regular branches of banks, mobile branches housed in vans should be established similar to those which operate in the rural areas of Great Britain. A mobile branch of a bank would be able to visit from 25 to 30 places in a week. This idea, however, has not found favour in banking circles in India for two reasons : first, people in rural areas would have no confidence in a banking office unless it exists permanently in their midst, and secondly, such vans would not be as safe as permanent bank premises in safe localities. It may also be interesting to remember that the Government has now appointed a high-powered committee to go into the question of extension of banking facilities in rural areas with Sir Purshottamdas Thakurdas as its president.

Reserve Bank in Action. The Reserve Bank started functioning under very favourable circumstances. The Bank Rate which stood at 6 to 7 per cent for more than nine months of 1931 had fallen to 3½ per cent in April, 1935. The Bank reduced it to 3 per cent in November 1935. It has thus reduced and stabilised the rate for money

and has offered cheap and valuable inland remittance facilities.[1] It has attained a remarkable measure of success in the management of the Public Debt and in the floatation of loans for the Central and Provincial Governments. It has encouraged the extension of banking facilities where they were not available or were inadequate. Scheduled banks' regulations have been amended so as to encourage them to open offices in moffussil areas. In order to help uniform development of credit facilities throughout the country, the Reserve Bank is now acting as banker to five of the seven Part B States. It has been making available short-term accommodation to the State Co-operative Banks on the concessional rate of 1½ per cent for financing seasonal agricultural operations and marketing of crops. Credit limits sanctioned to co-operative banks by the Reserve Bank increased from a little less than Rs. 7 lakhs during 1946-47 to Rs. 17·12 crores in 1953-54.

The Reserve Bank Act was amended in 1953 to enable it to provide medium-term loans to co-operative banks. The Bank has been contributing up to 20 per cent on the debentures floated by land mortgage banks since 1949. Every encouragement has also been given to the establishment of land mortgage banks in different States. On the recommendations of the Bank certain amendments were made in the Indian Companies Act in 1944 which came into force from July 1, 1946. According to these amendments a bank is prohibited from employing a managing agent, or any person whose remuneration or part of whose remuneration takes the form of commission or a share in the profits of the company, or any person having a contract with the bank for its management, for a period exceeding five years at a time. Banks incorporated after January 15, 1937, will have to satisfy several conditions : (1) Their subscribed capital must not be less than half the authorised capital and the paid-up capital not less than half the subscribed capital. (2) The capital must consist of ordinary shares only, or ordinary and such preference shares as were issued before July 1, 1944. (1) The voing rights of all share-holders must be strictly in proportion to the contribution made by the share-holders to the paid-up capital. Since the promulgation of the capital issue control on May 17, 1943, the Bank has furnished opinion on 604 banking and 239 insurance applications forwarded to it by the Government. With effect from February 15, 1945, it has allowed the non-scheduled banks to open accounts with itself with a minimum of Rs. 10,000. These accounts are not to be treated

The Reserve Bank introduced a new scheme of remittance facilities in October, 1940, the object of which is to extend the remittance facilities to non-scheduled banks and to make them cheaper. According to the scheme, whereas the rates to be charged to the public are 1/8 per cent for remittances up to Rs. 5,000 and 1/16 per cent for remittances above that amount, the corresponding rates for approved indigenous bankers, non-scheduled banks, and co-operative societies are 1/16 per cent and 1/32 per cent. Indigenous bankers and non-scheduled banks, however, must satisfy certain conditions *viz.*, that they must have a minimum owned capital of Rs. 50,000 and that banking must form their main business. They must also conform to the money-lending regulations of their respective provinces.

as ordinary current accounts and cheques in favour of third parties are not permitted. They can, however, be used for remittance purposes and inter-bank transactions. In short, the working of the Bank during the last 16 years has justified the claim that "it has inaugurated a new era of financial stability, banking reform, and extension and reorientation of the money market."[1]

No serious occasion has yet arisen to test the hold of the Bank over the money market. Ever since its inception easy conditions have prevailed in the market and the necessity of involving the aid of the Central Bank has not yet been felt by the market generally. It is also significant that up till now there have been no bills in the bank's portfolio other than Treasury Bills, which incidentally also bear testimony to the absence of a discount market in India. "Other loans and advances," that is, other than those given to Governments have also been conspicuous by their absence. There are certain features of the Indian money market which might cast doubt on the ability of the Reserve Bank to exercise an effective control over credit. For instance, the pre-eminent position of the Imperial Bank may rob the Reserve Bank of some of its usefulness. Then there is in the market a group of banks called the Exchange Banks which, if it should so elect, may frustrate a policy initiated by the Reserve Bank in view of its easy access to the London Money Market. Besides, it has been suggested that in a country like India, where the money market is not organised, the Reserve Bank can wield but little influence. These defects are, however, imaginary and the presence of the Imperial Bank or the resources of the Foreign Exchange Banks have not detracted the Reserve Bank from acting in the best interest of the country. As a positive evidence of the influence which the Bank has been able to exert on the money market may be mentioned the removal of seasonal stringency in the market as demonstrated in a uniform bank rate throughout the year. This has in its turn had salutary effects on other market rates. Prior to the establishment of the Reserve Bank, not only were the various rates high and fluctuating, but there was also much divergence between them. With the Reserve Bank in operation, considerable improvement has been effected in both these aspects, as the following figures will show :—

[per cent per annum]

Year	Bank Rate	Imperial Bank Hundi Rate	Calcutta Bazar Rate	Bombay Bazar Rate
1929	5	5	11	6
1930	7	7	11	9½
1939	3	3	6—7	6
1940	3	3½	6—7	6¾
1946	3	3	6—7	6—7
1947	3	3	6—7	6—7
1948	3	3	6—7	6—7

1 Jathar and Beri—*Indian Economics*, Vol. II, p. 502.

(Moreover, as has been pointed out before, the Bank has so far failed to assimilate the indigenous money-lenders in the banking system of the country and has not yet succeeded in developing a regular bill market.) It has also lost a good deal of public confidence on account of the questionable treatment meted out to the Travancore National and Quilion Bank. This scheduled bank was in serious difficulty in June, 1938 and applied for financial accommodation which was refused unless the bank subjected its accounts to thorough examination by the Reserve Banks. Such a scrutiny, the scheduled banks contend, should be made *before* and *not just when* a serious emergency arises. Moreover since the T.N. & Q. Bank had withdrawn a part of its compulsory deposits with the Reserve Bank, the latter's offer of help was limited to the funds still in its possession. This also is wrong in principle. "Central Bank aid should have no relevance to the volume of compulsory reserve lodged with it but only the general position of the bank and the volume of its realisable assets. If aid were to be limited to the volume of compulsory reserves, scheduled banks might as well keep their balances with themselves and forego the dubious advantage of affiliation."[1]

In 1949 five Scheduled Banks in West Bengal suspended payment. The total amount of deposits involved was Rs. 5·38 crores. The total book value of the assets was Rs. 6·73 crores although the realisable value was much less. The causes of the failure of these banks were, as usual, lack of experienced staff, over-extended loan portfolios, reckless policy of branch expansion, declaration of high rates of dividends despite poor reserves, speculative transactions in Government securities and unsound policy in granting loans and advances etc. (But even if it is admitted that bank failures were due to the defective internal organisation of banks themselves, the Reserve Bank, which is supposed to control and supervise their working, cannot be completely absolved of its responsibility in the matter.)

(Nevertheless, it must be admitted that the Bank has been, on the whole, quite generous and prompt in rendering assistance to banks whenever they needed it either for tiding over temporary scar- city of funds or owing to stringency in the money market to meet heavy panicky withdrawal of deposits.) In fact, with a view to localising disturbances in the banking structure and preventing the spread of scare, the Reserve Bank helped one or two institutions to an extent which they did not deserve. A typical example of this was provided by the Exchange Bank of India and Africa Ltd., which is now in liquidation. The Reserve Bank actually went out of its way to enter into a compromise with the liquidators at a considerable cost of the tax payers' money.

The administration of the Reserve Bank also needs improvement. Due to the lack of real expert *personnel* at the top, the Reserve Bank has proved to be nothing more than a costly continuation of the old system of departmental control of currency. In Great Britain it has

1 Muranjan—*Modern Banking in India*, p. 287.

been increasingly realised, especially in the last ten years, that both the Treasury and the Bank of England have to be considerably strengthened with men deeply versed in Economics and public finance. The additional *personnel* taken on both the Treasury and the Bank of England in recent years, therefore, comprise a large number of some well-known economists. The Reserve Bank of India has, in a scheme of controlled money, been obliged to take up multifarious duties the successful discharge of which can be accomplished only by constant additions, not of mere routine men, but of specialists who can claim to have practical experience and appropriate theoretical knowledge. It is, therefore, suggested that when the tenures of the Governor and the Deputy Governor expire the Government should try to secure the services of people well versed in the art and science of banking and public finance especially from among the young eligibles of this country.

Another interesting point revealed in the report of the Central Board of Directors is that the number of share-holders in the Bombay area has increased at the expense of other areas principally Calcutta and Rangoon. According to the Reserve Bank Act, each share-holder has one vote for each five shares subject to a maximum of ten votes so that if this tendency continues, blocks of shares might become concentrated in the hands of a few holders with the effect of restricting the electorate and the risk of detracting from the representative character of the directorate chosen by it. The Directors have reported the position to the Government with the suggestion that they might consider the limitation of the shares that a holder may register in his name to a maximum of 200 shares but the Government has not yet taken any action upon this recommendation.

Sir James Taylor has also drawn the attention of the Government to another important point, namely, that the deposit of 5 per cent of their demand liabilities and 2 per cent of their time liabilities which the Scheduled Banks are obliged to keep with the Reserve Bank is not quite satisfactory. These deposits work out probably on the average at about 3½ per cent of a bank's funds and there is nothing to prevent the banks from investing the rest of their funds in any way they like. Moreover, the banks are permitted to withdraw a part of the compulsory deposit provided they pay a heavy rate of interest by way of penalty. The very fact that the bank draws on its statutory deposit would of itself indicate that the bank had no security against which it could borrow money from the Reserve Bank and that most of its funds are locked up in frozen assets. Hence, in the interest of sound banking in general and to protect the depositors in particular, the Reserve Bank has recently[1] been empowered to prohibit, if necessary, a defaulting bank from receiving fresh deposits during the period of default and to penalise directors and other officers who may have been knowingly and wilfully party to a default. But to prevent bank failures and to save the Reserve Bank from

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1 November, 1940.

embarrassing situations like the one that cropped up in connection with the T. N. & Q. Bank, the need for some sort of closer control over scheduled banks is evident. Three measures of control have been suggested.[1] "The first is that no new banks should be incorporated without the assent of the Reserve Bank of India and the agreement of the Government of the Province in which the bank is to function. The second would be the appointment of Bank Examiners under the control of the Reserve Bank to perform periodical examinations. Such examinations must not be perfunctory or set to a fixed time schedule. They would be made in particular without delay in the case of any bank whose returns indicated loose or unsound working but they would have to be made with due circumspection. The third form of control would be the provision that a bank should carry a proportion of its liabilities in India in cash, call-money with the Reserve Bank or other approved depositors, and in securities approved by the Reserve Bank, *i. e.*, securities against which the Reserve Bank would be prepared to advance. In this respect a monthly return from all banks could be made obligatory, such return summarising principal assets and liabilities."

The war-time record of the Reserve Bank in respect of "monetary stability" has been none too bright. By meekly agreeing to fill its reserves by a huge mass of sterling securities[2] it has been instrumental in inflating currency and prices. In fact it would not be an exaggeration to say that the Reserve Bank has been acting as a mouth-piece of the Government and has not asserted itself even when the best interests of the country were being sacrificed in the name of the British war-effort. This is all the more deplorable in view of the fact that many prominent members of the central board have, in their private capacity, been vehemently criticising the policies of the Reserve Bank regarding prices, dollar, sterling and other economy controls. Perhaps the members were afraid of the special powers of the Governor-General by which he could remove from office the Governor, Deputy Governor or any elected or nominated Director and in special cases even supersede the Central Board and create another agency to do its job.[3] The Bank has also come in for a good deal of criticism for operating the dollar exchange control to the detriment of the country and for acting as the agent for the gold profiteers of the British Empire and the U. S. A.

Effects of World War II on Banking in India. Increase in the number of banks. Owing to the increase of trade, many new banks have come into existence and the old ones have opened

1 By the Editor of the *Journal of the Indian Institute of Bankers*, in its July (1940) issue, pp. 10-12.

2 The sterling securities rose from Rs. 59·5 crores on the 1st September, 1939 to Rs. 1014·3 crores on the 11th May, 1945, *i. e.*, a rise of Rs. 955 crores or 1605 per cent.

3 Sections 11 (1) and 30 of the Reserve Bank Act.

more branches.[1] Many branches have sprung up in places where banking facilities did not exist before. This tendency in India stood in marked contrast with the tendency abroad where due to the scarcity in man-power a large number of institutions had to be closed down. The multiplication of branches has not caused a fall in the volume of resources per branch. In most cases it shows improvement as is clear from the following table.

This expansion in banking business did not in any way weaken the banking structure of the country. In fact, there was actually a higher degree of concentration except perhaps in the case of Foreign Exchange banks whose business was adversely affected by the entry of Japan in War in 1941. The ground lost by the Exchange Banks was, however, captured by the Imperial Bank.

NUMBER OF BRANCHES AND DEPOSITS PER BRANCH

[in lakhs of rupees]

Banks	1939		1940		1941		1942		1943	
	No.	Deposit	No.	Deposit	No.	Deposit	No.	Deposit	No.	Deposit
Imperial Bank	173	57·3	174	61·7	177	67·9	179	67·7	...	...
Central Bank	114	28·7	132	26·9	155	29·9	163	38·7	188	...
Bank of India	20	103·6	20	122·2	22	127·5	22	177·4	24	...
Allahabad Bank	55	23·2	28	22·9	66	24·0	67	26·5	69	...
Baroda Bank	24	33·0	25	33·2	26	41·3	26	55·5	28	...
Punjab National Bank	66	11·7	69	12·4	72	14·5	71	19·9	112	...
Indian Bank	40	10·4	45	12·0	49	15·6	39	14·5	...	...
Union Bank	4	49·3	4	61·8	4	72·8	4	101·5	4	...
Bank of Bihar	13	10·4	15	8·7	17	8·8	19	9·3	20	...
Indo-Commercial Bk.	29	3·1	29	2·4	28	4·5	24	6·2	23	...
Bank of Hindustan	10	2·4	7	2·8	9	2·8	8	3·3	8	...

Increase in Deposits. The effects of the War on the deposits of the Scheduled Banks have already been traced[2]. It has been pointed out that although in the beginning the deposits tended to decline, public confidence did not take long to return and the deposits reached the high level of Rs. 261 crores in April 1940. With the intensification of hostilities in May, however, there set in a declining tendency and the total deposits fell sharply from Rs. 261 crores at the beginning of May to Rs. 250½ crores at the end of June, a fall of Rs. 11½ crores. The panic was soon allayed and the total deposits rose to about Rs. 292 crores in May, 1941, and stood at Rs. 914 crores in

1 The number of scheduled banks increased from 51 in 1939 to 76 in 1944 : and the total number of their offices, including the head offices, increased from 1328 to 2141 during the same period and to 3519 by the end of 1946. The number of non-scheduled banks having capital and reserve of between Rs. 5 lakhs and Rs. ½ lakhs increased from 231 to 293 but the number of those whose capital and reserve is less than Rs. ½ lakhs fell from 400 to 130.

2 Chapter XIII.

1946. On the whole, the deposits of the Exchange Banks, the Imperial Bank, other Scheduled Banks and the non-scheduled banks have increased by 110, 165, 250 and 170 per cent, respectively, during the six years of war. The bigger Indian banks have shown the greatest improvement particularly after 1942 when the entry of Japan in the war reduced public confidence in the Exchange Banks.

It will also be noticed that while the demand liabilities increased from Rs. 139·6 crores in 1939 to Rs. 654·5 in 1946, the time liabilities, during the same period, increased from Rs. 106 crores to Rs. 259·5 crores which means that the current deposits increased more than the fixed deposits. This is due to many reasons. Firstly, low rates of interest for fixed deposits have weakened the public desire to hold them and strengthened the tendency to hold liquid assets in the form of current deposits. Secondly, the public is unwilling to convert its savings into durable assets such as gold, shares and real estate on account of their inflated prices and has been holding the savings in the most liquid form so as to be able to purchase durable assets as soon as their prices go down. Finally, during the War, the savings cannot be used for the creation or extension of industrial establishments on account of the difficulty of obtaining industrial equipment. They have, therefore, to be used as increased working capital for obtaining enlarged output from the existing scale of equipment in establishments."[1] Mr. B.L. Punjabi[2] has attributed this disproportionate increase of demand deposits to the cautious attitude adopted by banks in financing the seasonal movements of crops owing to the fear that the accumulation of these crops at the ports resulting from the closing of a number of European markets and the difficulties with regard to freight might depress prices.

While the deposits of other banks have increased, the Post-Office Savings Bank deposits and investment in Savings Certificates have fallen presumably due to the decrease in the saving capacity of the lower middle classes who have been adversely affected by inflation and high prices.

Another interesting point is that the increase in deposits has not been accompanied by a proportionate increase in paid-up capital and reserves. This may prove detrimental to the interest of the depositors unless the banks take immediate steps to increase their capital and keep their assets in a more liquid and easily realisable form.

Advances and Bills Discounted. During the first seven months of the war when the total deposits of banks increased only by about Rs. 7 crores, the advances by banks, including bills discounted, increased by Rs. 46·67 crores and reached the figure of Rs. 163 crores which is the highest recorded since the inception of the Reserve Bank. This was obviously due to the sudden improvement of trade

1 *Supplement to Banking in India* by S. G. Panadikar, p. 2.

2 See his excellent notes on "Banking in India" in the *Journal of the Indian Institute of Bankers.*

and rising prices. But towards the end of March there was a sharp fall of prices and the banks did not lend as freely as before with the result that advances fell from Rs. 156 crores on March 29 to Rs. 99·59 crores on December 20 or by Rs. 56·87 crores and the discounts decreased from Rs. 6·64 crores to Rs. 2·21 crores *i.e.*, by Rs. 4·43 crores during the same period. As was to be expected, the percentage of banks' advances and discounts to their deposits, which reached the peak in March, 1940, declined from 62·5 to 39 by the end of the last year but again rose to 53 in May 1941 as the following figures will show :—

ADVANCES AND DISCOUNTS OF SCHEDULED BANKS

		Advances (in lakhs of rupees)		Bills Discounted (in lakhs of rupees)	
Date		Amount	Increase or decrease	Amount	Increase or decrease
August 25,	1939	105,27	...	3,99	...
September 29,	,,	112,44	+ 7,17	3,12	− 67
October 27,	,,	111,20	− 1,24	2,45	− 67
November 24,	,,	119,47	+ 8,27	3,26	+ 81
December 29,	,,	143,16	+23,69	4,68	+1,42
January 26,	1940	150,17	+ 7,01	4,86	+ 18
February 23,	,,	149,25	+ 92	5,84	+ 98
March 29,	,,	156,46	+ 7,21	6,64	+ 80
April 29,	,,	151,73	+ 4,73	6,80	+ 16
May 31,	,,	153,68	+ 1,95	6,97	− 23
June 7,	,,	148,41	− 5,27	6,03	− 54
July 19,	,,	132,11	−16,30	3,55	−2,48
August 16,	,,	123,28	− 8,83	2,24	−1,31
September 13,	,,	115,84	− 7,44	1,71	− 53
October 18,	,,	105,71	−10,13	1,60	− 11
November 15,	,,	99,32	− 6,39	1,94	+ 34
December 20,	,,	99,59	+ 27	2,21	+ 27
January 10,	1941	103,99	+ 4,40	2,80	+ 59
February 14,	,,	112,21	+ 8,22	4,61	+1,81
March, 14,	,,	118,56	+ 6,35	5,99	+1,38
April 18,	,,	130,92	+12,36	6,81	+ 82
May 16,	,,	131,74	+ 82	6,56	− 25
			+26,47		+2,57

On September 28, 1945, the bills and advances of the Scheduled Banks amounted to about Rs. 266 crores, that is, an increase of over 65 per cent since the commencement of the war. But despite such a great increase in the volume of bills and advances it must be remembered that their percentage to the total assets of the banks has

actually fallen from 62 to 25. "The reasons for the fall are large profits made by trade and industry and used by them as working capital, advance payments made by Government to contractors and producers, loss of overseas markets, shrinkage in the volume of import and export trade on private account, restrictions on the internal movements of goods, restrictions on advances against commodities, adverse effects of the war on certain markets such as jute and cotton etc."[1]

Among the bank's investments the premier rank came to be held by Government securities. As in the first war, so also in the second, the banks have played a major role in war finance and their deposits increased by the amount of their subscription of the Government loans.

Cash Position of Banks. But for seasonal fluctuations, the cash position has remained satisfactory throughout the whole period. With the exception of the first nine months of the war when there was some little decline, the proportion of cash and balances with the Reserve Bank to total deposits has always been above 12 per cent while for the greater part of the war period it has been considerably above that. The decrease in the percentage of bills and advances to total assets has only been partially offset by an increase in Government and other securities with the result that the average percentage of cash to liabilities of all banks has been unusually high. This means that the banks have been forced to keep a larger portion of their assets in a more liquid and, therefore, less profitable form and they have made up this loss by reducing interest on deposits.

Bankers' Balances with the Reserve Bank. The balances held by scheduled banks with the Reserve Banks of India amounted to Rs. 22 crores at the end of April but by June they had fallen to Rs. 19·63 crores. Thereafter, they showed an almost continuous rise and reached the figure of Rs. 51·89 crores in November 1940, which was about Rs. 40 crores in excess of the statutory minimum required by the Reserve Bank Act. In September 1945, the scheduled banks' balances with the Reserve Bank stood at about 114 crores, *i.e.*, Rs. 89 crores more compared to September 1939. A part of the increase, no doubt, indicated the anxiety of the banks to keep their resources liquid to meet possible withdrawals but the greater part of it reflected the seasonal demand for money.

Non-Scheduled Banks. Like the scheduled banks the non-scheduled banks have also stood the strain of the war very well. Barring the first few months of war when the rush for withdrawals was intense, both the demand and time liabilities have shown an appreciable increase. In December 1944, their total deposits were well over Rs. 50 crores, cash balances more than Rs. 6 crores and the percentage of cash balances to liabilities 11·4.

Conclusion. From what has been said above it is quite clear that the Indian banking situation, like the currency position, is quite

1 Panadikar—*Supplement to Banking in India*, p. 4. Also see Muranjan—*Modern Banking in India*, pp. 479-80.

sound. Our bigger institutions are so scientifically and skilfully run that it has not been found necessary for any one of them, except perhaps on one occasion, to have recourse to the Reserve Bank for advances against Government securities or for discounting of commercial bills. The same, however, cannot be said about the smaller banks. Some of them are good, some bad, some indifferent. It would be necessary, at some stage, to weed out the weaker ones by amalgamation or some such method. Meanwhile it would be most inopportune if any of them should find themselves obliged to suspend payment. Whatever one's views be about the desirability or otherwise of the aggregation of these smaller institutions, there must be general agreement on two main points, namely: (1) that like the poor, these banks have been with us for years and they are part of the banking organization and we cannot be blind to their existence, and (2) that they should not be allowed to come to grief at this juncture. The process of weeding out the inefficiently organized smaller banking institutions should await the return of normal conditions. At present, they should, if necessary, be bolstered up and assisted to bear the strain of abnormal economic conditions.

Peace Time Trends. After the war there was an inevitable decrease in the volume of economic activity financed directly by the Government and the consequent decline in working balances and the desire to keep these balances in liquid form with the result that while the amount of demand deposits increased from Rs. 584·8 crores in 1945 to Rs. 654·5 crores in 1946 and to Rs. 671·8 crores in 1947, the amount of time deposits shot up from Rs. 194·1 crores in 1945 to Rs. 259·5 crores in 1946 and to Rs. 343·5 crores in 1947. There was a slight recession again in 1948 but that was due to the difficulties and uncertainties created by the partition of the country in 1947.

On the assets side the changes were still more significant. Commercial banks unloaded their holdings of Government securities and began to lend more and more of their funds in the form of cash credits and against bills purchased and discounted both absolutely and in relation to their total liabilities. In doing so, the banks showed that they were no longer keen to sacrifice returns for the sake of safety. The total cash position of the banks improved but in relation to total liabilities it declined a little. All these changes are amply borne out by the figures given below :—

(In crores of rupees)

	Liabilities			Assets						
	Demand (1)	Time (2)	Total (3)	Advances in India (4)	Bills discounted (5)	Total (6)	Percentage (6) to (3) (7)	Cash (8)	Balances with Reserve Bank (9)	Percentage of (8) & (9) to (3) (10)
1944	456·6	142·8	599·4	156·1	5·6	161·7	26·6	20 5	63·6	14·1
1945	584·8	194·1	778·9	224·2	11·2	235·4	29·6	27·3	89·2	14·5
1946	654·5	259·5	914·0	285·1	16·1	301·2	32·8	34·8	89·9	13·8
1947	671·8	343·5	1015·3	413·0	16·4	431·4	43·0	39·9	91·2	13·6
1948	687·1	315·8	1002·9	442·4	17·1	459·5	46·0	35·5	84·2	12·8
	(81·5)	(19·6)	(101·1)	(37·8)	(1 0)	(38·8)	(39·0)	(4·4)		

N. B. Figures in brackets relate to Pakistan.

To control the malpractices that had crept into the banking system during the years of war, three pieces of legislation were passed. The Banking Companies (Inspection) Ordinance, 1946 empowered the Reserve Bank to inspect the affairs of any banking company and to take corrective action if it was found that the company was working in a way which was detrimental to the interest of the depositors. The Bearer Promissory Notes (Prohibition of Issue) Ordinance, issued in May 1946, prohibited the banks from issuing promissory notes payable to bearer. These promissory notes did not contain the name of the original purchaser and passed from hand to hand as a negotiable instrument till maturity. Thus virtually they became notes so long as they circulated and hence constituted a violation of the principle laid down in Section 31 of the Reserve Bank of India Act under which the Bank is entrusted with the sole right of note-issue. The Banking Companies (Restriction of Branches) Act, passed in November, 1946, prohibited banking companies from opening new branches or changing the location of existing branches without the previous permission of the Reserve Bank.

Effects of Partition on Banking. Just before the division of the country there was a great deal of panic and uncertainty about the future. Non-Muslims in Pakistan sent a large amount of their capital to Hindustan and the Muslims of India kept their assets in liquid form to be prepared for all eventualities. Fears were to a large extent allayed by the conclusion of a Standstill Agreement between the two Dominions according to which up to 31st March, 1948, there was to be a common currency between the two Dominions and the Reserve Bank was to act as banker to both.

Pakistan (Monetary System and Reserve Bank) Ordinance. On the eve of partition the Pakistan (Monetary System and Reserve Bank) Ordinance was issued by the Governor-General under Section IX of the Indian Independence Act, 1947. According to it the Reserve Bank was to manage the banking and currency of Pakistan till September 30, 1948. After April 1, 1948, the Bank was to issue notes in the name of the Government of Pakistan which was also expected to find the assets to back them up. One-rupee notes of the Government of India circulating in Pakistan were to be exchanged into Pakistan notes before September 30, 1948 and were to be returned to the Government of India. Other notes were to continue as legal tender up to the 31st March, 1949, and were to be accepted by the Pakistan Government at par up to that date in exchange for Pakistan notes. The Indian coins were also to continue as legal tender in Pakistan for one year or more after the introduction of its own coins by the Government of Pakistan, the exact period to be determined by the Pakistan Government itself. When the Indian coins ceased to be legal tender in Pakistan, they were to be disposed of as follows :—

(*a*) Nickel, brass and quaternary coinage to be melted and disposed of as metal by Pakistan ;

(*b*) Other coins were to be sold to the Indian Union which was liable to pay the bullion value as well as the minting charges.

Thus, coinage was the liability of the joint Governments, the liability for the face value and the ownership of the bullion value being split up in the proportion in which the coins were circulating.

The division of the sterling balance was equally simple. The assets of the Reserve Bank in the Issue Department were to be transferred to Pakistan in the ratio which the Pakistan notes bore to the total note-issue ; the proportion in which the different types of assets were to be transferred were to be the same as the proportion of these types of assets in the Bank's consolidated statement of accounts as on 30th September, 1948. The Reserve Fund and the surplus assets of the Banking Department were to be divided (*i*) in the proportion in which the uncovered debt of the Government of India was to be divided, and (*ii*) the assets of the Issue Department were taken over.

Relative Position of the Scheduled Banks in India and Pakistan soon after Partition. It was as follows :—

(in crores of Rs.)

Item	India (1)	Pakistan (2)	Total (3)	Percentage of (2) to (1)
Demand Deposits	625·03	65·47	690·50	10·4
Time Deposits	304·33	39·46	343·79	12·8
Total Deposits	929·36	104·92	1,034·29	11·3
Cash in hand	36·08	5·09	41·17	14·0
Balance with Reserve Bank	...	...	110·38	...
Advances	359·48	43·63	403·11	12·2
Bills discounted	15·20	1·32	14·52	8·5

Obviously the banking resources of Pakistan were not quite impressive, especially when compared to India. They were only a little over 10 per cent of the all-India total.

The Communal Disturbances. Partition was not as peaceful as some people had expected it to be. Serious riots broke out in the Punjab which, for a time, completely paralysed the life of the Province. Due to religious fanaticism which was suddenly let loose a large number of people were either killed or driven to places of safety and considerable quantities of goods in transit or godowns were destroyed or confiscated. The organised banks had probably anticipated the trouble and had accordingly transferred a part of their assets to India. Their loss was, therefore, not very great. The indigenous money-lenders who had lent money on personal security or on the

security of immovable property, however, suffered heavy losses the amount of which has not been estimated so far.

Banking Companies (East Punjab and Delhi) Ordinance. With a view to helping the banks in distress, the Reserve Bank was authorised to advance loans to all banks in India, whether scheduled or not, against any form of security which it deemed sufficient. This was followed by the Banking Companies (East Punjab and Delhi) Ordinance on 27th September, 1947 according to which the banks in East Punjab and Delhi were required to make payment to their depositors not exceeding 10 per cent of the total amount of the current and deposit account at each branch in India or Rs. 250, whichever was less.[1] The banks were also permitted to make similar payments to depositors who could satisfy the bank regarding the deposits in the branches outside the boundaries of the Indian Union. The banks were prohibited from accepting fresh deposits for a period of three months and from disposing of their assets.

Banking Companies (Pakistan) Ordinance. A similar Ordinance, called the Banking Companies (Pakistan) Ordinance was promulgated in Pakistan on 22nd October, 1947, but it is doubtful if any bank took advantage of it during the period of the moratorium.

The effects of the riots had worn off by the middle of October and by that time the banks in India had resumed their normal activities. They were only worried about the documents, safety vaults and the buildings left behind in Pakistan.

India's Refusal to hand over Cash Balances to Pakistan. Under the financial agreement the Government of India had agreed to allot to Pakistan Rs. 55 crores in cash in full and final settlement of its claims on the cash balances of the pre-partition Central Government. This was over and above the sum of Rs. 20 crores given in cash to the Pakistan Government on August 15, 1947. This was a generous gesture which Pakistan did not reciprocate and since it was suspected that the amount, if given, would be used by Pakistan to finance the invasion of Kashmir by tribal hordes, the Government withheld payment until all the outstanding points of dispute between the two Dominions had been amicably settled. But, in order to enable Mahatma Gandhi to break his fast which he had undertaken to bring about better relations between the two Dominions, the payment was duly made in the middle of January 1948. The position created by India's refusal to credit the balances at once was solved by Pakistan partly by drawing upon Provincial funds and partly by raising a loan of Rs. 10 crores from the Reserve Bank of India. The Nizam of Hyderabad also helped them by transferring some securities of the Government of India to the Government of Pakistan.

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1 By an amendment made on 13-12-47, payment of 30 per cent of the drafts or Rs. 750, whichever was less, was made obligatory on the Banks under moratorium.

New Pakistan Notes and Coins. On the expiry of the Standstill Agreement, the Reserve Bank issued separate Pakistan rupee notes inscribed with the words "GOVERNMENT OF PAKISTAN" in English and Urdu with effect from April 1, 1948. These notes are legal tender only in Pakistan and although they are issued by the Reserve Bank of India the responsibility of keeping them in circulation is that of the Government of Pakistan.

From the same date, new coins, minted in Lahore, have also been put into circulation. These coins have also been issued by the Reserve Bank. They are identical with the corresponding Indian coins in respect of denomination and value but they differ in design for the crescent moon and star are engraved on the obverse with the value written in Urdu and English.

New Central Bank for Pakistan. With effect from July 1, 1948, Pakistan has set up its own Central Bank called the Bank of Pakistan. It has a capital of Rs. 3 crores shared between the State and the public in the ratio of 51 : 49. For administrative purposes, there is a Central Board consisting of eight Directors and one local Board each at Karachi, Lahore and Dacca. The Bank has taken over from the Reserve Bank of India all powers in regard to paper currency, public debt, and exchange control. Its latest position can be judged from the following figures.

Corresponding figures for the Reserve Bank of India have also been given to facilitate comparison.

STATEMENT OF AFFAIRS IN MAY 1951

BANKING DEPARTMENT

	Reserve Bank of India	State Bank of Pakistan
	Liabilities	
Capital ...	5,00,00,000	3,00,00,000
Reserve Fund ...	5,00,00,000	3,00,00,000
Deposits :—		
(*a*) Central Government	1,33,01,91,000	81,00,75,000
(*b*) Other Governments	26,21,12,000	2,11,90,000
(*c*) Banks ...	52,78,68,000	12,29,25,000
(*d*) Others ...	78,85,64,000	5,46,09,000
Bills payable ...	5,18,78,000	7,34,000
Other liabilities ...	18,66,09,000	2,68,01,000
Rupees	3,24,22,22,000	1,09,63,34,000

	Assets	
Notes	... 9,29,99,000	8,64,55,000
Rupee coin	... 11,43,000	4,000
Subsidiary coin	... 1,53,000	27,000
Bills purchased and discounted :—		
(*a*) Internal	... 37,00,000	...
(*b*) External	... ...	...
(*c*) Govt. Treasury Bills	3,36,16,000	5,15,54,000
Balances held abroad	...1,83,00,80,000	65,23,05,000
Loans and advances to Government	... 6,92,00,000	5,00,000
Other loans and advances	22,62,87,000	3,10,04,000
Investment	... 87,26,64,000	21,19,96,000
Other assets	... 11,23,80,000	6,24,89,000
	Rupees 3,24,22,22,000	1,09,63,34,000

ISSUE DEPARTMENT

	Reserve Bank of India	State Bank of Pakistan
	Liabilities	
Notes held in the Banking Department	... 9,29,99,000	8,64,55,000
Notes in circulation	13,02,47,32,000	2,04,21,21,000
Total liabilities	13,11,77,31,000	2,12,85,76,000
	Assets	
Gold coin and bullion	7,38,16,82,000	1,29,43,39,000
Rupee coin	... 56,97,86,000	3,92,02,000
Government securities	5,16,62,63,000	75,25,60,000
Held in the Reserve Bank of India pending transfer to Pakistan :—		
(*a*) Gold coin and bullion	...	19,02,000
(*b*) Sterling securities	...	3,06,12,000
(*c*) Government of India securities	...	70,10,000
(*d*) Rupee coin	...	29,51,000
	Rupees 13,11,77,31,000	2,12,85,76,000

Statistical Comparisons. In order to study the position of banking in the two Dominions since partition the following figures

will be found to be very instructive :—

TABLE A

Scheduled Banks [in crores of rupees]

	15-8-'47	22-8-'47	9-4-'48
1. Demand liabilities—			
(a) in India	...	625·03	687·29
(b) in Pakistan	...	65·46	81·83
(c) Total	675·36	690·49	768·82
2. Time liabilities—			
(a) in India	...	304·33	315·82
(b) in Pakistan	...	39·46	19·64
(c) Total	343·58	343·79	335·46
3. Balances with Reserve Bank	99·86	110·38	84·24
4. Advances—			
(a) in India	...	359·48	442·44
(b) in Pakistan	...	43·63	37·82
(c) Total	408·06	403·11	440·26
5. Bills discounted—			
(a) in India	...	15·20	17·16
(b) in Pakistan	...	1·32	·96
(c) Total	16·02	16·52	18·12
6. Cash	143·29	...	123·81

These figures indicate that while in India conditions had become more or less stable by April 1948, conditions in Pakistan were far from satisfactory. To be more concrete, while the demand liabilities in India had increased from Rs. 625·03 crores in July 1947 to Rs. 687·29 crores in April 1948, these liabilities in Pakistan during the same period increased from Rs. 68·46 crores to Rs. 81·83 crores only. The position in regard to time liabilities was still worse. While in India there was an increase of Rs. 11½ crores, in Pakistan there was a fall of about Rs. 20 crores showing that people in Pakistan were still afraid of their deposits with banks in Pakistan for long periods. The total amount of advances and bills discounted by the Hindustan Banks increased from Rs. 374·68 crores to Rs. 459·60 crores, similar investments in Pakistan declined from Rs. 44·95 crores to Rs. 38·78 crores. The figures relating to bank finance also tell the same tale.

Indo-Pakistan Banking Agreement. It was made in 1949. An Implementation Committee set up according to the Agreement met in June 1950 with a view to studying the working of the Agreement with special reference to the position of Indian banks having branches in Pakistan and the question of the transfer of deposits belonging to persons who have migrated from one country to the other. Important decisions acceptable to both countries were arrived at.

Industrial Finance. While a good deal is being done to help the agricultural development of the country, the need for rapid industrialisation of the country does not seem to have been sufficiently

realised. It is a well-known fact that India has an enormous potential wealth possession as she has a variety of raw materials, but instead of utilising them for the development of her industries she has been merely content to export them to be converted into intermediate products and finished goods in other countries. She is, therefore, wholly dependent on foreign countries for the supply of intermediate products like the plant and machinery and chemicals which she requires and the production of which may be regarded as the index of the industrial progress of any country. "The need for rapid industrialisation can hardly be exaggerated from a purely economic point of view as it will tend to absorb that portion of the population which cannot be supported by agriculture, will provide a remedy for the gradually increasing unemployment among the middle-class people, and will result in an improvement in the standard of living generally.[1]" The problem has become particularly important because of the war which has just terminated. New industries have been started (*e. g.*, chemical, radio-manufacturing, etc.) and others are under contemplation (*e.g.*, aircraft and motor car manufacture, ship-building[2] etc.) but until suitable provision for financing these and other prospective industries is made no ocular results of any value should be expected. The following pages will, therefore, be devoted to the examination of the needs of different industries with suggestions for providing adequate financial assitance.

The Requirements of Industries. Broadly speaking, an organised industry requires two kinds of finance : fixed or block capital and floating capital or short-term accommodation for its day-to-day needs. The former includes not only the initial loans which are required for purchasing land, erecting factory buildings and installing plant and machinery, but also the more or less permanent funds which an old established concern needs to extend and reorganise itself. The floating or working capital is required for the purchase of raw materials and stores, for expenses incidental to the marketing of products and for providing the necessary funds for paying wages and meeting the day-to-day requirements. A part of the working capital is also of permanent nature.

The relative proportion between block and working capital required by an industry naturally depends upon the nature of the industry itself. The more roundabout and complex the process of production, the greater must be the proportion of fixed to working capital. For instance, in the case of hydro-electric, iron and steel, jute and cotton industries block capital is very large in relation to working capital. On the other hand, in case of cottage industries which require less expensive tools and implements, working capital

1 *Central Banking Enquiry Committee Report*, p. 262.

2 A beginning has already been made by the Scindia Steam Navigation Company.

plays a more important part.[1]

In between the above two kinds of credit, long and short-term, industries frequently require credits for intermediate periods, *i.e.*, for periods varying from one to five years. Provision has, therefore, to be made for all the three kinds of financial facilities, *viz.*, short, medium and long-term although, as we shall see presently, the third form is by far the most important.

Existing Facilities—Major Industries. The working capital of major industries is usually derived from four sources, *viz*: (1) public deposits ; (2) private deposits including the sums of money advanced by the entrepreneurs, their friends and the managing agents ; (3) indigenous money-lenders ; and (4) the joint-stock banks. Let us briefly consider the part played by each of these in the financing of industrial enterprise in India.

The system of public deposits prevails largely in the cotton textile industry of Bombay and Ahmedabad. The mill-owners of these places are often able to attract large sums of money by way of deposits from the people of their own community, especially from those seeking safe yet profitable investment for their small savings. This system of industrial finance proves quite successful, in normal times but it has certain inherent weaknesses. For instance in times of stringency, mills whose financial position is not strong find real difficulty in obtaining deposits. In fact the tendency of depositors to withdraw their money on the slightest rumour of difficult times ahead puts the mills in a most awkward position.[2]

The private deposits of entrepreneurs and their friends have also played an important part in financing the medium-sized and comparatively new industries in India like the tea-gardens of Bengal and Assam and some of the sugar and match factories. But by far the most important of source of industrial finance is the managing agents. All the more important jute mills, cotton mills, tea-gardens and the greater part of sugar factories, electric supply companies and light railways were established and are still managed by them.

A managing agent combines in himself the functions of the entrepreneur, the capitalist and the business-manager and it would not be an exaggeration to say that "a number of prosperous and flourishing industries of today would have yet been in the womb of future without the initiative of managing agents."[3] Nevertheless, the system of financing by managing agents has been open to grave defects. For example, it is an open secret that the surplus funds of one

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1 The amount of working capital needed in an industry depends mainly upon the value of the output and the average length of time occupied by the productive process. But there are other governing circumstances as well. The time at which a manufacturer gets paid and the methods of buying raw materials and effecting sales often affect the amount of working capital needed by a particular industry. See P. S. Lokanathan, *Industrial Organisation in India*, pp. 157-58.

2 Also read N. Das, *Industrial Enterprise in India*, pp. 8-10.

3 S. K. Basu, *Industrial Finance in India*, p. 165.

mill are often invested in the shares and debentures of other mills and that the funds raised on the credit of one concern are occasionally lent to another under the same managing agents. The number of companies under the control of a managing agent is usually so large that it becomes impossible to finance *any one* adequately. Trading and speculation by managing agents is another great defect because the banks are known to have withdrawn their cash credits from agents who lost in speculation although the mills themselves were intrinsically sound. Some of the methods adopted by the managing agents in financing industry are also questionable. For example, in many cases they have turned their loans into debentures with the result that the concerns have passed into their hands and the shareholders have lost all their capital invested in them. The managing agents of the present age, moreover, unlike their predecessors, have no knowledge of manufacture—engineering, technical or scientific. They are not experts in buying and selling and "the various irregularities committed in filing balance-sheets, lists of shareholders, extraordinary resolutions with the Registrars of Joint Stock Companies are an illuminating commentary on their knowledge of commercial law and training in secretarial work."[1] Under the circumstances, the financing of industries should be made less dependent on the managing agency system than hithertofore.

The importance of the indigenous bankers in the realm of industrial finance is gradually diminishing. They are now mostly patronised by the small industrialist who does not wish to "expose himself to the enquiries, the regularised procedure and the greater risks of a joint-stock bank with a grilled counter and the uniformed peon in the doorway"[2] and is, in consequence, willing to pay higher rates of interest. Coal companies, for instance, have to borrow money from the indigenous bankers for the practical development of their collieries at as high a rate as 12 to 18 per cent and sometimes even at 24 per cent. Industries like leather tanning, oil mills, rice mills, smaller tea-gardens etc., have to pay as high as 24 per cent even when they borrow on the security of their assets.

The ordinary commercial banks employ their short-term deposits for providing working capital to the principal industries of the country, *viz.*, jute, cotton, iron and steel etc. The advances given by these banks fall under two main heads : (1) advances against tangible and and marketable security lodged or pledged with the lender, (2) clean advances against personal credit with a second signature to the pronote. In India there are very few clean advances without a second signature—a class of advances that occupy an important place in the highly developed banking system of Europe and America[3].

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1 Basu, *op. cit.*, p. 190.
2 N. Das, *Industrial Enterprise in India*, p. 14.
3 *Central Banking Enquiry Committee Report*, p. 380.

It should also be remembered that the most useful form of borrowing in India is the *cash credit* account under which an advance is allowed against a promis-

(*Continued on next page*)

The attention of the Central Banking Enquiry Committee was drawn to the fact that in making loans banks are generally willing to take account only of tangible and easily realisable assets like stocks, etc., but not of block capital. It was also pointed out that margins as large as 30 per cent and more were claimed and enforced against tangible and realisable assets and that the rates charged were more than the industry could bear. But all said and done it may be assumed that the demand for short-term industrial credit is satisfied fairly, cheaply and adequately. The same, however, cannot be said about long-term capital. The Indian investing public is proverbially shy and often reluctant to make direct investment in industries[1] and the insurance companies invariably prefer government or semi-government securities to industrial paper. The Imperial Bank even now cannot make any loan or advance for a period exceeding nine months and is not permitted to lend upon mortgage or in fact against any immovable property except in the case of estates under the charge of Court of Wards. The other Indian joint-stock banks are essentially commercial banks who cannot afford to lock up their short-term liabilities in long-term investments. The share of the Exchange Banks in industrial financing is practically nil. They were founded and are controlled by foreigners and they cannot possibly have any interest in the indigenous industries. Even otherwise the nature of their business precludes long-term industrial financing. Hence, the industries often raise long-term loans either by issuing preference or debenture shares none of which is unfortunately very popular in this country.

The difficulties pointed out above have often been emphasised to make out a case for separate industrial banks as distinguished from the ordinary commercial banks, *i.e.*, for creating separate institutions dealing with long and short-term credit respectively. There is, however, hardly an example in economic history where such a separation of banks has existed and has expedited industrial and economic progress. On the contrary, examples of countries which adopted mixed banking and hastened their industrialisation are more numerous. In Germany, for example, the ordinary banks play a very important part in satisfying the financial requirements of industries. They provide the greater part of the initial capital which is subsequently

(Continued from previous page)

sory note signed by the borrower and secured by the hypothecation of stocks. Under this system, interest is paid by the borrower only to the extent to which the credit is availed of from day-to-day and he can reduce his obligation at any time subject, in some cases, to a minimum interest clause, *i.e.*, subject to the provision that the bank would charge its clients interest on a minimum amount which is generally one-half of the maximum limit of the drawing power allowed to the borrower by the bank. Similarly, the lending bank can curtail and withdraw the facilities at any time. The system is thus advantageous to both sides.

1 *Joint-stock Companies.*

	(in Calcutta List)	(in Bombay List)
Share Capital...	Rs. 76·37 crores	Rs. 52·83 crores.
Debentures ...	Rs. 8·65 ,,	Rs. 17·51 ,,

Indian Central Banking Enquiry Committee, Vol. 1, Part II (Minority Report), p. 335.

placed among the investing public. In order to distribute the risk it is a very common plan for several banks to join together in a *Konsortium* and pledge themselves to accept a certain portion of the issue. In Italy, Belgium and the U.S.A., the banks generally used to engage in "mixed" bankings (combining short-term with long-term industrial financing) until the great economic depression of 1929-33 which demonstrated the drawbacks and disadvantages of the mixed system. It must, however, be emphasised that the banks invested only a limited portion of their resources in industrial finance and that ordinary banking business constituted their major activity. The Central Banking Enquiry Committee also suggested the establishment of direct friendly relations between industrial companies and commercial banks[1]. But they overlooked the fact that not one of the joint-stock banks of India, with the possible exception of the Imperial Bank, is fitted today to embark on the undoubtedly difficult and complex policy of "mixed" banking. The reasons are obvious. Firstly, most of these banks have meagre resources in paid-up capital and reserves and they cannot afford to lock up short-period deposits in long-term advances. Secondly, there is still a very low level of understanding and integrity among many of the bankers today and, until things improve, it would be dangerous for them to embark on "mixed" banking operations. Thirdly, the whole story of industrial finance in India shows that investment by banking institutions which are organised as commercial banks inevitably leads to speculation and rash promotion.[2]

As a result of the experience gained during the years of the economic depression it has been generally agreed that long-term industrial finance should be eschewed by banks. Apart from the "mixed" type of banks which have declined since the depression, special industrial banks have been established in some of the European countries. In France, there were the "Banques d' Affaires," which specialised in the issue of securities and in the floatation of industrial and financial undertakings. In Finland, an industrial mortgage bank was floated in 1924 with capital supplied mostly by the joint-stock banks, to meet the long-term requirements of industry. The National Hungarian Industrial Mortgage Institute Ltd., was founded in 1928 for granting amortisation loans to industry, the Treasury contributing 80 per cent of the capital and the National Union of Manufacturers the remainder. In Poland, the Economic Bank was brought into existence in 1926 which was empowered, among other things, to make industrial loans. The capital of this bank was subsequently acquired by the State.

Industrial Banks. Hence, while we support the policy of establishing better contacts between the commercial banks and industrial concerns, we do not under-estimate the importance of purely

1 For a very able discussion of this point see Muranjan—*Modern Banking in India*, pp. 156-161.

2 N. Das, *Industrial Enterprise in India*, pp. 42-43.

industrial banks. Such banks have been tried by Germany and Japan with conspicuous success. The German Banks attend on industrial undertakings "from their birth to their death ; from promotion to liquidation." These banks, called *Gross-bankerns*, actively participate in industrial ventures by taking up and underwriting and eventually selling blocks in these ventures. They exercise a great measure of control over the industries through their representatives and directors. They have a highly paid staff to evaluate the assets and the possibilities of failure of fresh industrial schemes. In Japan also the growth of industries has been fostered by the Industrial Bank of Japan which was established in 1902. After the great economic depression, the Reconstruction Finance Corporation was created in the United States of America with the object of extending financial assistance to agriculture, commerce and industry. The activities of the corporation were considerably extended during World War II to enable it to aid the defence programme. Even England, the home of *laissez faire*, has realised the wisdom of establishing such institutions as the securities Management Trust and the Bankers' Industrial Development Trust.[1] In addition to these there are institutions specialising in instalment financing. The United Dominions Trust, the largest of such institutions, the Banking Facilities Trust, and the Mercantile Credit Company, etc., specialise in hire, purchase and deferred-payment agreements. These companies assist new enterprises by financing the purchase of equipment and machinery on easy instalment payment system. The United Dominions Trust also set up a subsidiary company in 1934 called the Credit for Industry with the object of giving loans to small tradesmen, manufacturers, and others engaged in various forms of industry requiring additional resources in semi-permanent form. In January 1945, two new Finance Corporations were formed, namely, the Finance Corporation for Industry Ltd., and the Industrial and Commercial Finance Corporation Ltd. The purpose of the former company is to provide finance for industrial business with a view to their quick rehabilitation and development in the national interests and that of the latter to suply medium and long-term capital to the small and medium-sized business of the country. In Canada, an Industrial Development Bank has been brought into existence as a subsidiary to the Bank of Canada to ensure adequate credit to industrial enterprises which may reasonably be expected to prove successful. In Australia, an Industrial Finance Department has been created in the Commonwealth Bank to assist in the establishment and development of industrial undertaking. The first industrial bank of India was the Tata Industrial Bank. It start-

1 These institutions were set up in 1930 under the auspices of the Bank of England with the main object of salvaging depressed industries. The purpose of the Industrial Development Trust was to provide necessary finance for pushing through schemes of rationalisation and reconstruction of such industries as ship-building, cotton, iron and steel while the object of the Securities Management Trust was to take up and administer the industrial interests of the Bank of England remaining over from the period when the Bank did ordinary commercial banking business or which it had accepted in the national interest during the depression.

ed work in 1918 but had unfortunately to suspend the industrial side of its activities in 1922.[1] The Industrial Commission had also urged the necessity of establishing such institutions in 1919.[2] The Central Banking Enquiry Committee recommended the establishment of Provincial Industrial Corporations to provide better financial facilities to industries within their jurisdiction and an all-India Industrial Corporation to finance industries of great national importance, particularly those which cannot be supported out of Provincial resources. An all-India bank is expected to command not only ready finance but large capital with necessary safety to investors as it would be able to engage financial experts. The question again assumed great importance in 1945 in connection with the schemes formulated by the Government of India for the post-war industrialisation of the country. In the statement on Industrial Policy issued by the Government on April 21, 1945, with reference to their plans for the future industrial development of the country, the Government stated that the question of the proportion of an Investment Corporation or similar institution was under examination.

Whether Share-holders' or State-owned ? Whether such banks should be started privately or with the help of the State is a debatable point. Those in favour of State-aid harp upon the shyness of Indian capital and suggest that only an industrial bank aided by the State can mobilize capital and turn it into productive channels. They also point out that an institution aided by the Government would inspire the confidence of all investors who would, therefore, take more interest in industrial issues and debentures and this change of outlook on their part would eventually be to the advantage even of those undertakings that have not come to the bank for financial help.

Those against State interference, on the other hand, maintain that State-aid through a bank is not likely to solve all the difficulties with whch the industries in India are faced nowadays. In fact they believe that a State-aided Bank would lead to political pressure of various kinds and would probably lead to the suppression of industries which are likely to compete with vital industries of foreign countries. Considering, however, that an Industrial Bank requires a large amount of capital and expert *personnel* for assessing the soundness or otherwise of the various industrial undertakings some sort of Government assistance seems to be quite desirable. Therefore, the ideal bank for the moment should be started with private capital and enterprise and the Government should insure the promoters and share-holders against losses.

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1 For the present position of Industrial Banks of India read Muranjan, *Modern Banking in India*, pp. 163-165.

2 The Industrial Commission had suggested that thc Industrial Banks should possess the following features :—

(1) High paid-up share or debenture capital.
(2) Distribution of the loans over a good number of industries instead of staking everything on the success of a few.
(3) Careful scrutiny and limitation of loans.

Industrial Finance Corporation of India. With the inauguration of the independent Dominion of India and our anxiety to go ahead full speed of the industrial development of the country, the Government took steps to set up an Industrial Finance Corporation. A bill was accordingly introduced in the Constituent Assembly on 20th November, 1947, which having been suitably modified by the Select Committee became law on 13th February, 1948.

The share capital of the new Industrial Finance Corporation has been fixed at Rs. 10 crores, though only half of this amount will be issued in the beginning. The authorised capital is divided into 20,000 fully paid-up shares of Rs. 5,000 each. Co-operative banks have been entitled to subscribe to these shares with a maximum limit of 10 per cent of the total issued. The proportion of other shareholders is as follows : Central Government 20 per cent, Reserve Bank 20 per cent, Scheduled Banks 25 per cent and insurance companies, investment trust and other financial insitutions 25 per cent.

The Corporation will give financial help to public limited industrial concerns, and co-operative societies in India, including all those Indian States which are willing to abide by the laws made by the Dominion legislature on the subject-matter of the Act. Loans can be given either in Indian currency, or in any foreign currency, if it is thought appropriate. This provision is necessary, because in the present state of affairs industrial concerns in India would be requiring capital abroad for the purchase of plant and equipment, and in view of the difficulties of foreign exchange, which are bound to persist for some time to come, it may be difficult for an individual company to obtain the necessary exchange for the purchase of capital goods. A corporation of this kind which would be enjoying the patronage of the Government of India might be in a better position to make arrangements for the supply of the necessary foreign exchange for this purpose. For example, the International Bank for Development Resettlement or the Import and Export Corporation of the United States are bodies which are more likely to lend to a Corporation like the Industrial Finance Corporation of India than to any private individual or corporation. In other words, this Corporation would, in the very nature of things, enjoy greater facilities for raising loans abroad than any private individual company.

With regard to the payment of dividend, it has been provided that until the Reserve Fund becomes equal to the share capital and until all subventions granted by the Government in virtue of their guarantee are repaid, the dividend declared shall not exceed the guaranteed rate of the Government dividend which really means that assuming the guarantee rate is somewhere round about the market rate of Government securities, the dividend would not exceed that rate for at least ten years and even after that period the maximum dividend permissible is 5 per cent.

The affairs of the Corporation will be administered by a Board

consisting of 12 Directors. Of these six will be nominated by the Reserve Bank and the Central Government and the rest by other shareholders. The Board will be assisted by Advisory Committees who will examine the financial position and prospects of a concern which wants to borrow money from the corporation. The balance in the Board is such that Government can exercise very effective control. Over and above this, there is a provision that Government would be entitled to issue, from time to time, directives to the Board on the question of policy and the Government will be the sole judge as to what are questions of policy and what are not.

A recent amendment to the Reserve Bank of India Act will enable the Bank to undertake the issue and management of loans on behalf of the Corporation. The Corporation is a statutory body and the Government has guaranteed a minimum return on its shares. It is in the fitness of things, therefore, that it should be placed on the same footing as the Central Government and the Provincial and State Governments in the matter of having their loans managed by the central banking institution of the country.

Another amendment made in the Industrial Finance Corporation Act seeks to permit institutional investors to invest money in the share capital of the corporation by putting these shares in the list of approved securities. Provision for the setting up of a provident fund scheme for the employees of the corporation has also been made.

Though sponsored by the State, the Corporation will be required to pay income-tax and super-tax.

The Corporation, as we have seen, is neither owned nor managed exclusively by the State. Private enterprise has been given equal representation in management. Yet the control exercised by the Government is very rigid and there will not be the slightest scope for any group of private individuals to manipulate the operations of this Corporation to the individual advantage of any one person or group of persons. Should the experiment prove a failure, the Government has been empowered to acquire the shares of private shareholders by paying them the capital value of the share plus one per cent more for every year from the date of issue to the date of acquisition, subject to a maximum of 10 per cent.

The first annual report of the Corporation covering the year ended 30th June, 1949, makes encouraging reading. The progress made by it during this period has been satisfactory and if it continues to display that spirit of service and enthusiasm which underlined the first year of its operations it will have fully served the purpose for which it was created.

To be more precise, the Corporation sanctioned loans amounting to Rs. 3·42 crores, the type of industries and the amount of

accommodation allowed to each being as follows :—

	Industry		Amount sanctioned (in lakhs of Rs.)
1.	Textile Machinery	...	43·00
2.	Mechanical Engineering (oil engines)	...	10·00
3.	Chemicals	...	56·50
4.	Ceramics and glass	...	60·00
5.	Cement	...	40·00
6.	Electrical Engineering	...	26·00
7.	Oil mills	...	1·75
8.	Electric power	...	3·00
9.	Metallurgical industry (non-ferrous)	...	30·00
10.	Iron and steel (foundries)	...	15·50
11.	Cotton textiles	...	40·00
12.	Woollen textiles	...	5·00
13.	Unclassed	...	11·50
			3,42·25

A province-wise analysis of the industrial concerns which have been sanctioned accommodation shows that West Bengal has received the largest amount, namely Rs. 75·5 lakhs, spread over three concerns. Then comes Madras with Rs. 75 lakhs for three concerns, followed by Bombay (Rs. 73 lakhs for six concerns), Bihar (Rs. 55·50 lakhs for three concerns), Orissa (Rs. 40 lakhs for one concern), East Punjab (Rs. 15 lakhs for two concerns), and the U. P. (Rs. 8·25 lakhs for three concerns). These figures relate to 1952. Progress in subsequent years has been equally satisfactory.

Nevertheless, the Corporation has been subjected to much adverse criticism. For instance, the prospective borrowers have complained of delays in the disbursement of loans and in the consideration of loan applications. Moreover, it is pointed out that while the conditions for lending are onerous, the rate of interest, which is 5 per cent, drives potential borrowers to seek help direct from the Government which has lent money in the past for similar purposes at marginally lower rates of interest. Hence, reforms leading to the elimination of cumbersome and time-consuming procedures will undoubtedly go a long way in enhancing the usefulness of this premier agency of industrial credit.

Other Agencies for Financing Large Scale Industries. On account of the difficulty of one corporation to finance industries spread over a very wide area, finance corporations are being started in all major states. There are six of them already. Many more are likely to come into existence before long. In addition to these, there are two other important organisations, namely, the National Industrial Corporation (N. I. D. C.) and the Industrial and Credit Finance Corporation (I. C. & F. C.). The first one (N. I. D. C.) is mainly a Government concern. It has been started primarily to finance the activities of projects started by the State. It may also assist industries

in the private sector if their development is considered essential from the national economic point of view, such as jute and cotton textile industries. The I. C. & F. C. is a private enterprise. Out of its total paid-up capital of Rs. 5 crores, Rs. 3·5 crores has been subscribed by Indian nationals (individuals and institutions), Rs. 1 crore by the British investors and Rs. 50 lakhs by U.S. investors. The association of foreign capital with the corporation is significant. It shows that the Government is prepared to encourage the import of foreign capital provided it is not otherwise detrimental to the best interests of the country. The fact that the World Bank has agreed to give it a loan of $10 million (about Rs. 5 crores) is proof of its economic soundness. The I. C. & F. C. will encourage industrial development in the private sector by granting loans either for the establishment of new industries or for the expansion and rehabilitation of existing industrial concerns in the private sector. It will also subscribe to the share capital of industrial concerns promoting new ventures or underwrite the issue of such concerns. In addition, it will assist them, if need be, by providing technical know-how by getting experts from abroad. Where it takes up shares or under-writes the issue of shares, it will try not to have a controlling interest in the capital structure or the management of industries concerned.

There are some people who feel that there was no need for establishing the I. C. & F. C. at all. According to them the Industrial Finance Corporation of India could well perform all the functions now assigned to the I. C. & F. C. Theoretically speaking, there is some force in this contention. Nevertheless, the case for two or three development corporations can be defended even in theory. It can be argued, for instance, that the task of financing the industrialisation of the country is so great that there is room for all the three big corporations. But far more important is the practical point of view and there is every reason for welcoming the setting up of the I.C. & F.C. on this ground. *First*, the old Industrial Corporation (I. F. C. I.) has, unfortunately, not been able to diversify its activity. *Secondly*, although it was meant to be an independent body, free from Government interference, in recent years, it has become, for all practical purposes, an official organisation, owing to the control sought to be exercised by Parliament. In view of this "officialisation" of the Corporation, it is very doubtful if it can get the support of foreign investors. *Thirdly*, the I. F. & F. C., has a much wider scope for activity than either the I. F. C. I. or the N. I. D. C., and is assured of the necessary talent to exploit this scope. In short, this corporation can be expected to operate with utmost flexibility and facilitate the inflow of private capital and technical knowledge from abroad. Further, it can make available to both the I. F. C. I., and the N. I. D. C., the technical services it employs for examining the soundness of the projects placed before it for getting finance and for supervising the execution of such projects. It will thus prove to be a very valuable addition to the financial agencies in the country.

Finance for Small-scale Industries. The small-scale industries present difficulties of their own. For instance, their shares and

stocks, if ever they exist, have hardly any market value. They are generally under-capitalised; their products lack standardisation. They buy their raw materials in the retail markets and sell their products mostly on a wholesale basis. Consequently, their earnings allow meagre or no profit margins. Where Governments buy their products, payments on their purchases are inordinately delayed, thereby resulting in needless hardship. Many small-scale industries were started during the war attracted by the scarcity conditions of a seller's market. Now, with the return of a buyers' market, they are experiencing serious difficulties. Controlled by relatively obscure management and existing in scattered and obscure places, the technique of financial aid and supervision have to be on a different scale and altogether different in character.

Many agencies are trying to provide credit facilities to small-scale industries. One of them is the State. Under the State Aid to Industries Act, the State Governments can offer long-term and medium-term credit. But such aid has so far been insignificant. Besides, delay in sanctioning loans often discourages the borrowers from obtaining finance from this source. Then there are the State Finance Corporations. These institutions are new to the field and the cautious manner in which they have started their operations indicates that their assistance will not be appreciable, at any rate, for some time to come. There is also an apprehension that the indiscriminate establishment of too many State Corporations would result in locking up the available funds by them rather than providing the industries with funds. Hence, it would be better to have Special Development Corporation to provide long-term finance to small-scale industries. This corporation, though a separate and specialised department, should take a lead in organising small-scale industries and rendering assistance in the matter of co-operative or joint purchase of raw materials, standardisation of products, organised marketing, distribution and publicity.

Industrial co-operatives are another type of agencies providing credit for small-scale industries. These societies cater for such industries as weaving, oil pressing, tanning and leather work, coir and rope-making, smithy and carpentry, metalware, pottery and salt. They are reported to have done good work and deserve every support from the authorities. The Reserve Bank can also help them through the co-operative banks.

It should, however, be pointed out that the provision of financial facilities alone will not solve the problems of small-scale industries. These industries are generally badly organised and unless the basic structural defects are removed, money spent on them may not yield satisfactory results. To achieve this result, small-scale producers should be brought together to effect improvements in the organisation of production and the marketing of produce. The uneconomic units should be eliminated. Concentration of business in fewer hands would enable introduction of new methods of production which would facilitate attraction of more credit. There should also

be a close cooperation between all the credit agencies on the one side and the industrialists on the other.

Indian Companies Act of 1913 as amended in 1936. Some important amendments to the Indian Companies Act of 1913 which came into effect on January 15, 1937, have established a certain amount of banking control contemplated by the Banking Enquiry Committee in 1929. The most important aspects of this recent legislation may be summarised as follows :—

1. *Segregation of Banking from Commercial Operations.* A banking company is defined as a company which carries on, as its principal business, the accepting of deposits of money on current account or otherwise subject to withdrawal by cheque, draft or order. Banking companies found after January 15, 1937, must conform the objects of transactions to those enumerated in the amended Companies Act, (Section 277 F.)

2. *Cash Reserves.* Banking companies are required to keep as cash reserves 1½ per cent of their time liabilities and 5 per cent of their demand liabilities and to file every month with the Registrar a statement of the amount so held.

3. *Reserve Fund.* Banking companies are required to build up a reserve fund by allocating to it 20 per cent of the annual net profits until the fund is equal to the paid-up capital.

4. *Special Status of Scheduled Banks.* The special status of the scheduled banks has been recognised and statutory controls as, for instance, in the matter of building up reserves which have been applied to non-scheduled banks, have not been extended to scheduled banks on the ground that the latter can be left to the general supervision and control of the Reserve Bank.

It will be observed that these provisions deal only perfunctorily with banking business and do not touch more important issues, like licensing of banks and restricting the activities of foreign exchange banks etc., suggested by the Banking Committee.

Banking Legislation.[1] The working of the Reserve Bank Act and the Indian Companies Act in the last five years demonstrated the need of comprehensive legislation to control banking business and to promote its orderly development in this country. Sir James Taylor, therefore, submitted a scheme for the consideration of the Government of India the main provisions of which were :—

(1) To apply the proposed legislation to all those institutions which accept deposits withdrawable by cheques.

(2) Every company engaged in such business shall have to include as part of the name of its business any of such words as "bank", "banker", or "banking". No such company shall employ individuals as managing agents or be managed by a company other than a banking company.

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1 Also read Chapter II of the Annual Report of the Reserve Bank of India for the year ended December 31, 1949.

(3) For each branch which a bank opens in any of the three Presidency centres, namely, Madras, Bombay and Calcutta, the bank shall have a paid-up capital of Rs. 5 lakhs for each such centre. And for every branch that a bank opens in a centre where there are already two branches of other banks, the bank in question must have a paid-up capital of Rs. 50,000. The minimum paid-up capital of any bank is fixed at Rs. 50,000.

(4) Every bank should hold 30 per cent of its current time liabilities in the form of Government securities.

(5) Liquidation must be made more promptly and liquidation proceedings simpler and speedier.

(6) Co-operative banks will be excluded from the operation of the proposed legislation.

The scheme aimed at a simpler and more restricted definition of banking and banking companies than is contained in the Indian Companies Act (Section 277-F) and more particularly at remedying the institutions existing anomaly under Section 277-G of that Act under which institutions incorporated prior to January 15, 1937, may continue to call themselves banks and yet refuse to comply with the statutory provisions relating to banking companies. It also sought to ensure that an institution calling itself a bank had sufficient capital and that banks with inadequate resources did not open branches in the large towns where branches of other banks already existed. It also contemplated certain moderate restrictions on bank investments in order to protect the depositors and attempts to provide for simple and quick liquidation proceedings so that in the event of a bank failure the depositors may be paid off with the minimum of delay and expense of litigation. The proposed measure was expected to go a long way in safeguarding the interest of the depositors and generally in putting banking on a surer footing. But the Government took action not until 1944, when a new section 277-HH. was added to the Companies Act. Under this section no banking company could employ any person whose remuneration took the form of commission or share in the profits of the company or any person having a contract with the company for its management for a period exceeding five years. Section 277-I, now amended, laid down that no banking company incorporated on or after January 15, 1937, could carry on business unless its subscribed capital was not less than half the authorised capital, and the paid-up capital not less than half the subscribed capital and unless the capital of the company consisted of ordinary shares only or ordinary shares and such preference shares as might have been issued before the commencement of the Act. It also provided that the voting rights of all share-holders should be strictly proportionate to the contribution made by them to the paid-up capital of the company. These provisions, coupled with the promulgation of Rule 94-A of the Defence of India Rules relating to the control of capital issues restricted the growth of mushroom banking institutions.

In 1944 and again in 1946 attempts were made to introduce a

comprehensive Banking legislation but they had to be dropped for want of time.

Pending the enactment of the Banking Companies Bill, 1946, and with a view to controlling the unplanned expansion of branches and checking certain undesirable developments such as excessive expenditure on branches in relation to their resources, employment of untrained staff, etc., a Bill for the licencing of branches of banking companies was introduced in the Legislative Assembly on 4th November, 1946. After approval by the legislature, the Banking Companies (Restriction of Branches) Act, 1946, received the assent of the Governor-General on 22nd November, 1946, and became effective from that date. The Act lays down that no banking company shall open a new branch or change the location of an existing branch without obtaining prior permission in writing from the Reserve Bank which before giving such permission to any bank would take into consideration its financial condition and history, the general character of its management, the adequacy of its capital structure and earning prospects and the public interest to be served by the branch and, if necessary and with the previous approval of the Central Government, cause an inspection to be made of the books of account and other documents of the bank through a competent person.

The Banking Companies Bill introduced in 1948 became an Act in March 1949. One of the major changes effected by it in the law previously applicable to banking companies is the definition of the term "banking." It defines "banking" as the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise. Section 7 of the Act provides that, after the expiry of two years from the commencement of the Act, no company, other than a banking company, shall use as part of its name any of the words "bank", "bankers" or "banking" and that no company shall carry on the business of banking in any Province of India unless it uses as part of its name at least one of such words.

Section 10 of the Act prohibits the employment of managing agents and places restrictions on certain forms of employment by banking companies. It also prohibits the employment by a banking company of a person on a remuneration disproportionate to the resources of the company. In order to enable the Reserve Bank to determine whether the remuneration paid by a banking company is on a scale disproportionate to its resources, banking companies are required to submit to the Reserve Bank, before the 31st January each year, a return showing the remuneration paid to their directors and the first ten highest paid officers during the previuos calender year.

Section 11 prescribes the minimum capital requirements of banking companies while section 12 regulates the relationship between the authorised, subscribed and paid-up capital of such companies incorporated on or after January 15, 1937. It also restricts the voting rights of share-holders and prohibits the issue of preference shares.

With a view to preventing interlocking of directorates of banking companies, a provision has been made in section 16 under which a banking company incorporated in India is prohibited from having as director any person who is a director of another banking company. Section 19 is intended to prevent banking companies from carrying on trading activities by acquiring a controlling interest in non-banking companies. Section 20 places restrictions on loans and advances and Section 21 empowers the Reserve Bank to determine the policy in relation to advances to be followed by banking companies generally or by any banking company in particular, where it is satisfied that it is necessary or expedient in the public interest to do so. In terms of section 22, every company is required to obtain a license before commencing banking business in India. Section 26 requires every banking company to submit to the Reserve Bank a return of all accounts in India which have not been operated upon for ten years. Section 27 provides for the submission of monthly returns by banking companies relating to their assets and liabilities in India. Section 29 provides for the preparation of a balance sheet and profit and loss account in a prescribed manner. Section 35 empowers the Reserve Bank to inspect banking companies while Part III of the Act deals with the suspension of business and the winding up of such companies.

Banking Companies (Amendment) Act, 1950. This Act amended the banking legislation in four important directions, the objects of the amendments being :—

(*a*) to empower the Reserve Bank to control opening of branches by Indian banks in foreign countries ;

(*b*) to extend the scope of the term "assets" which every banking company has to maintain in India at the close of the last working day of every quarter, at not less than 75 per cent of its demand and time liabilities therein ;

(*c*) to facilitate quick amalgamation between banking companies ; and

(*d*) to provide for the speedy disposal of winding up proceedings in the case of banks and for punishing offences in relation to companies being wound up.

Adjudication of Bank Disputes. For many years the relationship between banks and their employees has not been very happy partly owing to the progressive rise in the cost of living and the slow and inadequate rate at which compensation for such increase was granted by the banks. Demands for higher salaries, increased dearness allowances and other facilities became the order of the day, invariably resulting in a number of disputes. Some of the Provincial Governments tried to find a solution for this unrest among bank employees by referring the disputes to their industrial courts or tribunals—but the results varied from province to province and gave rise to other complications because the majority of banks had branches in more than one province. Considering the fact that the Provincial awards

covered such subjects as leave rules, provident funds, salaries, and scales of promotions, dearness allowance etc. To enable the banks to get over these difficulties, the Industrial Disputes (Banking and Insurance Companies) Ordinance was issued on May 1, 1949. The Ordinance, which extended to all the provinces of India, provided for the prohibition of references by Provincial Government of any industrial disputes relating to banks and insurance companies for adjudication, enquiry and settlement. Even disputes pending before Provincial tribunals had to be dropped. They were then to be referred to the tribunals appointed by the Central Government.

On the expiry of the Ordinance on 30th October, 1949, it was renewed for a further period of six months. The provisions of the Ordinance were incorporated in an Act passed in December 1949. This Act, like the Ordinance which it replaced, prohibits State Governments referring disputes between the employees and the banking and insurance companies, having branches in more than one State, to any officer or authority, subordinate to themselves, for adjudication, enquiry or settlement. Such disputes fall under the jurisdiction of the Industrial Tribunal established for the purpose by the Central Government. The All-India Industrial Tribunal (Bank Disputes) held sittings in various States and has since issued an Award.

Socialisation of Banking. In recent years an acute controversy has arisen over the question whether banking and financial institutions ought to be left in private hands or transferred to some form of public ownership and control. The demand for nationalisation has come mostly from the Socialists who see a socialised banking system an indispensable instrument both for the carrying through of any co-ordinated plan of industrial development and for the extension of public ownership and control over productive industry. There are some who are opposed to any public ownership or control of joint-stock deposit banking, but they are strongly in favour of nationalisation of the Central Bank. Their argument usually is that the control of the volume of credit, which is the most important factor in determining the level of prices, is effectively in the hands of the Central Bank which is thus able to create conditions leading either to business expansion or monetary stringency and trade depression. This power, it has been argued, has been far too much disposed to wield not in the interests of national industry but rather in those of the money market and of a traditional doctrine of "sound" monetary policy. These non-Socialist advocates of socialisation are, however, usually determined to exclude, if they can, any form of actual governmental or parliamentary control over the working of socialised Central Bank. They would prefer it to be brought under the control of a statutory corporation, dominated by business men, and therefore more regardful of the needs of the industry than of the claims of the money market.

There is nothing revolutionary or socialistic in the idea that a country's Central Banks should be either a national institution or sub-

ject to some form of public control. The Central Banks of the U. S. A., England, France, Italy, Canada, New Zealand, Paraguay, etc., are all public institutions and their policies are directed by considerations of public advantage rather than profit-making in any direct sense. These banks are usually conducted by persons appointed by the Government for their technical competence and personal suitability rather than as nominees of divergent interests. While matters of detailed administration are free from official administration, the State controls matters of high policy as well as the rights of appointing or dismissing persons in charge of the administration. The Ministers of State answer in Parliament for the affairs of the Bank but Parliamentary discussions are always confined to matters of policy.

The problem of socialising the business of deposit banking, however, raises many other issues. For whereas the control of the Central Bank affects mainly the total amount of credit available for use in the community, and therewith the level of prices, the conduct of deposit banking affects rather the ways in which this available supply of credit is distributed among different claimants. If a Central Bank, by means of its open market policy, its regulation of the rate of discount, and its influence on other rates of interest, makes a certain amount of credit available for use in the community, the deposit banks have a strong incentive to put all the available money into use; for otherwise they find themselves in possession of assets on which they are unable to earn any profit. Accordingly, the expansion of the supply of credit by the Central Bank will usually cause the deposit banks to be on the look-out for fresh opportunities for using their resources.

Moreover, the deposit banks often find themselves with a certain amount of credit which they can create. By distributing this credit in different ways they can cause expansion or contraction of one industry as against another, or direct a larger or smaller proportion of the total volume of credit to industry as against other uses. Hence, if it is intended to develop industry by some sort of economic planning, control of banking is almost inevitable. Those who are opposed to the idea of socialising deposit banking contend such a step would be unpopular not only with business men but also with a large number of people who keep their private accounts with the banks and do not want public authorities to know their financial affairs. Another objection which is often advanced is that depositors will not feel the same assurance of the security of their deposits if the care of these is taken over by the State. It is also sometimes asserted that centralisation of banking in the hands of the State would ignore the needs and interests of the small producers and concentrate the supply of credit upon those great enterprises with whose success the fulfilment of an economic plan is bound up. Likewise, it is feared that State banking would discriminate in granting or refusing loans and that the granting of loans to particular firms or persons would become a political question.

These arguments are, however, not very convincing. Opportunities for tax evasion should be made as small as possible in order that tax burdens may be distributed fairly. And that public need not be apprehensive of its deposits, especially if the Government made it quite clear that the entire authority and credit of the State will be placed behind the security of the deposit lying in the banks. The strangulation of small scale enterprise may not take place except when it is in accordance with an approved plan and in that case even the Socialists will not be sorry because they themselves want to avoid losses arising out of the multiplication of small enterprises involving a great diffusion of energy.

There is a certain amount of speculation regarding the shape of the deposit banks after socialisation. Some expect a complete amalgamation of the existing institutions under unified control. This is, however, improbable because such an organisation would be too unwieldy to admit of proper management. In the long run what would probably happen would be that all the existing separate banks would disappear and their places would be taken over by a number of closely related banking institutions which would specialise in particular types of finance.

Nationalisation of the Reserve Bank of India. The question of nationalisation of the Central Bank has been ceaselessly discussed in this country also. Almost two decades ago, in September, 1927, the Gold Standard and Reserve Bank Bill was dramatically abandoned because the Finance Member, Sir Basil Blackett, did not like the idea of a State Bank. A great deal have happened since then. Paraguay, Italy, New Zealand and Canada nationalised their Reserve Banks. Ireland went in for a State Bank in February, 1943. Australia overhauled its banking system and adopted the Commonwealth Bank Act 1945—enunciating in Section 8 certain broad aims of policy. The French Assembly adopted the nationalisation law in December 1945. The Bank of England Bill received Royal Assent in February 1946 ; and nearer home, the Burmese Currency and Coinage Act 1946 constituted an *ad hoc* board of five nominated members to take over from the Reserve Bank. Following these examples, the Government of India also decided to nationalise the Reserve Bank as soon after the 30th September, 1948 as possible.

The shares of the Bank were acquired at the average of the monthly market value of the shares during the period March 1947 to February 1948, taking the opening quotation for each month and issued in lieu thereof to the shareholders 3 per cent long-dated stock of equivalent value of appropriate maturity.

Some people feared that after nationalisation the Reserve Bank may lose its independence. This fear was, however, baseless, for the examples of other countries showed that nationalisation need not necessarily destroy independence. Section 9 (1) of the Australian Commonwealth Bank Act 1945 enacts that the Bank shall from time to time inform the Treasury of its monetary and banking policy. If there is a difference of opinion between the Treasury and the Bank,

which may well develop because even the packed official Advisory Council of five members contains three from the Bank, the Treasury and the Banks are to endeavour to compose their differences ; a directive from the Treasury regarding policy has been prescribed only in the last resort. In England, even after nationalisation, any directions which the Treasury gives to the Bank can only be after consultation with it at the highest level.

The Reserve Bank, after nationalisation, was to be treated as a commerical department but the net advantage in terms of money were rather doubtful. Rs. 20 lakhs which were being paid to the share-holders as dividend were expected to be saved as also the payment due to the Reserve Bank for managing the public debt. But as against this saving the new stock issued in lieu of the shares were to entail a payment of about Rs. 16 to 18 lakhs.

The question of the disposal of surplus profits of the Reserve Bank after nationalisation was also not very complicated provided a definite charge was created. For instance, it could be arranged that after payment of interest on the Government stock issued to shareholders these should be paid into an *ad hoc* Government fund out of the surplus profits of the Bank an equated annual sum which will amount, in course of 20 years or in whatever period of maturity of the Government stock was ultimately decided upon, to the face value of the replacement stock which was issued. The remainder of the surplus was to accrue to the Government. Nationalisation was also expected to put an end to complaints regarding the concentration of shares in fewer hands. That these complaints were perfectly justified could be seem from the following table :—

DISTRIBUTION OF SHARES AS ON 30-6-47

Area	No. of Shareholders in			
	1935	1936	1946	1947
Bombay	28,000	22,342	17,368	17,362
Calcutta	28,870	15,571	10,590	10,457
Delhi	23,000	16,744	10,589	10,317
Madras	14,000	9,702	6,610	6,392
Rangoon	3,157	1,914	535	503
Average No. of Shares.	5·4	7·5	10·9	11·1

The Government also accepted the policy of nationalising the Imperial Bank which owed its existence to a special Act of the Indian Legislature. Since the bank has branches outside India, the Government would have to examine carefully the various technical

questions involved before the policy was implemented. The shares of the Imperial Bank would also be acquired by the Government on the same basis as n the case of the Reserve Bank but the period for which the average of the market value of the shares would be taken will be determined at the time of nationalisation. There is, however, no intention to nationalise the commercial banks.

Review of Banking Business in India. Having reviewed the principal types of banks and banking business in the country, we may now sum up their chief characteristics and short-comings.[1]

1. Practically all the banking business in this country today is of the orthodox commercial type, familiar chiefly in Britain. Our banks have no concern directly with the all-round economic development of the country, its productive capacity or distributive justice.
2. That banking is a public utility anda social service capable of producing new wealth and so improving the general standard of living scarcely seems to be realised in this country.
3. The existing banks mostly deal in commercial finance and do not render much assistance to the currency system of the country. Thus there is no direct link between the currency and credit systems and the volume of currency in circulation is practically impossible to expand or contract with the varying needs of business.
4. Banks have not developed Forms or Instruments of credit which could help to minimise the use of metallic money and the reserves needed against paper currency. There is no means to mop up and utilise the surplus of production over consumption as soon as it is formed. Such devices as the postal cheque or the Giro system which before the war, were quite common on the continent of Europe, are unknown in India. Even travellers' cheques and letters of credit operate in a very limited field and mostly by non-Indian banking interests.
5. There are not sufficient banks to meet the needs of such a large country and its vast population. The existing banks are largely concentrated in capital cities. Some sort of decentralised banking of the American type will have to be encouraged.
6. Though India is a vast country, two States alone, namely, Bombay and West Bengal, are the principal seats of banking in so far as they account for more than 50 per cent of the resources and enjoy the maximum benefits of modern banking. These are followed by Madras, Uttar Pradesh, and Delhi and the aggregate share of these five States is so large as to suggest that there is very little of banking in the

1 National Planning Committee—Currency and Banking, pp. 60-65.

rest of India. These facts are amply borne out by the regional distribution of offices, deposits and advances of scheduled banks as on December 31, 1949.

Region	No. of offices	Deposits (in crores of Rs.)	Advances (in crores of Rs.)
Total for India ...	2,788	842	425
Bombay ...	452	274	131
West Bengal ...	212	179	131
Uttar Pradesh ...	429	68	31
Madras ...	534	62	46
Delhi ...	85	55	15

7. Banking in India is still largely dominated by non-Indians who have evolved the pattern and set the model.

In its Annual Report on the Trend and Progress of Banking in India submitted by the Reserve Bank to the Government in October 1950 the following defects have been pointed out :—

(*i*) **Management.** Some of the directors of banking companies lack the knowledge and experience necessary for the exercise of adequate supervision over the activities of the chief executive officers, which enables these officers to exercise wide powers while making investments and advances. In a few cases the system of internal audit and inspection was found to be defective. Some banking companies were in the habit of declaring dividends without making adequate provisions for bad and doubtful debts, depreciation, in investments or other unrealisable assets etc.

(*ii*) **Investment Policy.** In the case of some banking companies, investments in Government securities were low in proportion to their resources, while, in a few cases, frequent borrowing reduced the liquidity ratio. Some banks held shares of companies in which some of the directors were interested and also shares which were not readily marketable.

(*iii*) **Lending Policy.** The advances of some of the banks were entirely out of proportion to their resources and, in a few cases, clear advances preponderated, while the machinery for investigating the credit-worthiness of the borrowers was defective. Some banking companies ignored the principle of diversification of risks.

(*iv*) **Branch Banking.** It was observed in the case of some of the banking companies that the system of supervision over branches was unsatisfactory, and regular returns of advancces etc., were either not called for or not properly scrutinised at the head office.

SUMMARY

Members of the Indian Money Market. The Money Market in India consists of the Indigenous Bankers, the Joint-Stock Banks, the Foreign Exchange Banks, and the Imperial Bank on one side and the Reserve Bank on the other. Reference has been made to Post-Office Savings Banks, Co-operative Banks and Land Mortgage Banks.

The Indigenous Bankers. They have existed in India from time immemorial under a variety of names and have rendered very useful service to the country. Their business, which is handed down from father to son, consists in giving loans against different forms of securities. They seldom accept deposits but readily invest their money in discounting *hundis* and in speculation. They are frequently denounced for charging very high rates of interest and for keeping mysterious accounts. Most of this criticism will lose weight if it is remembered that the money-lenders deal with illiterate people who are always anxious to forget and repudiate their liability. In addition to the risk of life and property, the growing apathy of law courts may also be held responsible for the desire on the part of the *sahukars* to protect themselves by charging high rates of interest. Moreover, the flexible terms offered by them and their pleasant manners, alertness and personal interest are invaluable assets which are lacking in other banking institutions. They can certainly be made more useful by adopting up-to-date methods of banking like keeping proper accounts, use of cheques etc., and by being combined into a sort of a co-operative bank.

In 1937, the Reserve Bank propounded a scheme by which the central banking facilities could be extended to the indigenous banks also, provided they satisfied certain conditions. But the scheme was not well received. The indigenous bankers are neither willing to abandon their age-old business nor to make their financial position known to the public although they are prepared to supply necessary information to the Reserve Bank when required. The Reserve Bank formulated another scheme in 1938 for providing finance for the marketing of agricultural produce through the agency of the money-lender. Even that had to be abandoned on account of the opposition of the scheduled banks.

Joint-Stock Banks. They are registered under the Indian Companies Act. First started with the help of foreign capital, they have had a chequered career. Many banks failed before the war owing to the inefficiency of management and indifference of the Government and the episode was repeated first in 1923 and then in 1932. A majority of them are now controlled by Indians. They perform all the normal functions of a bank and thus help the internal trade of the country but take no part in the external trade. Their practices are still far from satisfactory. They are advised to increase their cash balances and to consolidate rather than to extend the existing business.

Foreign Exchange Banks. They have headquarters in foreign countries and are not registered in India. They finance the foreign trade of the country by purchasing and discounting foreign bills of exchange, by making advances against shipping documents and by issuing foreign letters of credit. Because they are financed and officered by non-Indians, the Central Banking Inquiry Committee suggested that they should be required to take out a licence and should undertake to train Indians for executive posts. An All-India Foreign Exchange Bank to be started with the help of the Government was also suggested by them.

Although the existing banks have made steady progress, they continue to keep alarmingly low cash balances. It is high time that they were compelled by law to maintain a fixed higher percentage of their total deposits in India and not to disturb it in spite of what may happen outside.

The Presidency Banks. They were private institutions. In the beginning they were financed by the Government (and hence allowed to issue notes) but after 1861 they were gradually deprived of official patronage except in that they occasionally served as Government bankers. They did not possess sufficient funds of their own nor was there any co-ordination between them. They were thus incompetent to finance the growing trade of the country and after some hesitation were amalgamated into the Imperial Bank in 1921.

The Imperial Bank. It was started with a capital of Rs. 11½ crores. In addition to the functions of an ordinary joint-stock bank, it acted as banker to other banks and to the Government of India. It was not allowed to deal in foreign exchange. During its 35 years of successful career, it has rendered useful service to the country. It has extended banking facilities and put the idle balances of the Government at the disposal of trade and commerce of the country. Nevertheless, the bank has come in for a good deal of criticism on account of its free use of Government funds and predominantly non-Indian management. The Bank must be purged of its evils before it can usefully play the role marked out for it in future.

Co-operative Banks. They owe their existence to a desire on the part of the Government to prevent the agriculturist from the exploitation of the money-lender. They lend money at low rates of interest and have great educative value. The village or town banks are called primary societies. They are financed partly from within and partly by the Central Banks which are themselves financed by the Provincial Banks. The Co-operative Movement has only touched the fringe of the credit problem of India and the indigenous bankers continue to be the principal source of finance for the rural population. The Reserve Bank has recently made numerous suggestions for the improvement of the co-operative movement.

Land Mortgage Banks. Their object is to lend money for long periods for productive operations and to enable agriculturists to redeem their mortgaged property. These banks require more efficient management than the ordinary banks and when started on co-operative basis they rely on outside experts and Government assistance. The existing Land Mortgage Banks of India are mostly of the quasi-co-operative type and they have not proved very helpful so far.

Post-Office Savings Banks. They aim at inculcating habits of banking and thrift among middle classes by receiving deposits, by issuing Cash Certificates and by offering insurance policies to Government servants. In order to prevent the progress of these banks from being inconveniently brisk, certain restrictions have been imposed as to the amount that an individual can deposit but experience does not justify these restrictions. Post-Office Savings Banks are still few and far between and they ought to be extended to the areas which are not accessible to other institutions.

Deficiencies of the Indian Money Market. The development of the money market is not commensurate with the size and resources of the country. There is one bank to every 1,774 square miles and to every 329,598 heads of population. The deposit per man is also incredibly low, namely Rs. 6. This compares very unfavourably with other countries of Europe and even with other members of the British Empire Special credit agencies like Industrial Banks are conspicuous by their absence and the commercial banks frequently undertake tasks for which they are ill-fitted. Agriculture is still dependent on the mercy of the disinterested *sahukar* who is only interested in fleecing his clients alive. Branch banking is still in its infancy and is more useful to the urban than to rural areas. The functions of currency and credit were, till lately, vested in opposite directions. Poor cash balances, restricted use of cheques, want of co-ordination between the different members of the money market, instability of money rates, and absence of rediscounting facilities are some of the other defects of the money market which throw in relief the immediate necessity of establishing a Central Bank in the country.

Meaning of a Central Bank. A Central Bank has been described as "the people's agency to govern their supply of currency and credit free from any undue influence of politics of profits." It is entrusted with the right of note-issue ; the right to hold the reserve of other banks ; the right to buy and sell securities ; and the right of discount with the help of which it can control and co-ordinate the functions and activities of the different members of the money market. A central bank is also expected to control the credit situation in the country. The objects of credit control and the methods adopted to secure that end have been discussed at length and their limitations pointed out. A central bank also acts as a Bankers' Bank and as banker to the Government of the country.

A State or Shareholder's Bank. The Hilton Young Commission had recommended a Central Bank for India (in the form of the Reserve Bank) but the

bill authorising it aroused great controversy especially on the point as to whether it should be a State or a Shareholders' bank. Those who favoured State control urged that in a country full of illiterate people a Government bank will inspire greater confidence than a private institution. A bank can also be rid of profiteers by handing control to the Government and can be used as an instrument for creating additional currency in times of grave national emergencies. Those who favoured a shareholder's bank feared that the Government may misuse its privileges and continuity of policy may not be secured with changes in party politics. Considering that the activities of the Government of India are generally regarded with suspicion, a private bank was preferred to a State bank. Anyhow, the Bill was dropped and a comprehensive banking enquiry was ordered.

The Banking Enquiry Committee recommended the establishment of the Reserve Bank and made valuable suggestions for financing the external trade, for improving the bill market, for regulating banking and for disseminating banking education. These recommendations were ultimately incorporated in the Reserve Bank Act of 1934.

The Reserve Bank Act. The Bank was started with a capital of Rs. 5 crores divided into shares of Rs. 100 each and subscribed by people from different Provinces. The Bank has now been nationalised. The general superintendence was vested in a Central Board of Directors consisting of 16 members including one Governor and two Deputy Governors who are wholetime paid officials. The Board was advised by five Local Boards—one for each area—in matters relating to their respective areas. The bank was authorised to receive deposits without interest, rediscount bills, purchase and sell gold and sterling, give loans to governments and banks against approved securities, accept articles for safe custody, act as agent to the Government of India and other Native States and to issue bank notes. It was not allowed to engage in trade, purchase shares or shares of other commercial or industrial concerns, give loans against mortgaged property or to give interest on deposits. Every scheduled bank was required to maintain a fixed proportion of its deposits with the Reserve Bank. Armed with these powers and privileges, the Bank has been able to control and regulate banking in India and render invaluable assistance to trade and industry and more particularly to agriculture. It has now been nationalised.

Rural Finance and the Reserve Bank. Unlike a trader or a manufacturer, an agriculturist cannot borrow money cheaply. partly because the security against which he borrows is uncertain and partly because he does not satisfy the conditions on which alone modern banks are prepared to oblige him. Even the Reserve Bank has refused to deal with him except through intermediate agencies like the indigenous money-lenders and the co-operative societies provided these agencies are prepared to reorganise themselves according to the suggestions made to them through the Agricultural Credit Department. After World War II there has been a considerable improvement in the economic condition of the farmers. To consolidate these gains, adequate banking facilities in the rural areas are essential. The Government will be well-advised to subsidise the commercial banks in extending these facilities. The introduction of mobile banks is also suggested.

Reserve Bank in Action. The Bank has succeeded in reducing and stabilising money rates and in offering cheap remittance facilities. It has also helped Government to raise loans and to reform banking legislation. The bank has, however, not yet succeeded in establishing better contact between the indigenous bankers and the other members of the money market. Nor has it yet developed a regular bill market. It also failed to save the Travancore National and Quilon Bank from failure. Suggestions have also been made for the improvement of administration and for removing those defects of the Reserve Bank Act which have been revealed during the last six or seven years.

Effects of the Seccnd World War on Banking in India. The bank stood the strain of war very well indeed. Many new banks were started and the old ones opened more branches. The total deposits increased although the time liabilities went down a bit which is not surprising considering that the people were anxious to keep their money as liquid as possible. The banks also rendered adequate assistance to trade and industry. This is clear from the figures of advances

and bills discounted as well as from the statistics relating to bankers' advances with the Reserve Bank.

Peace Time Trends. After the war, time deposits increased faster than demand deposits. The banks also invested more and more money in trade bills as against Government Securities but their cash position in relation to liabilities declined to some extent.

Effects of Partition on Banking. The Pakistan (Monetary and Reserve Bank) Ordinance, 1947 promulgated on the eve of partition defined the position of the Reserve Bank after 15th August 1947, and laid down the procedure by which the Bank would cease to be the Central Bank of Pakistan. The partition of the country led to considerable bloodshed and destruction of property. The bigger institutions which had anticipated trouble did not suffer as much as the indigenous bankers who had lent money against personal security or against the security of immovable property which they had to leave behind. The Banking Companies (East Punjab and Delhi) Ordinance and the Banking Companies (Pakistan) Ordinance were passed in the Dominions of India and Pakistan respectively to help the banks in distress.

From the 1st July, 1948, the State Bank of Pakistan has been the Central Bank of Pakistan.

Statistical comparisons show that while conditions in India have become normal, those in Pakistan are still far from satisfactory.

Industrial Finance. Industrial development is necessary both for its own sake as well as for the purpose of stimulating agricultural improvements and for remedying unemployment, But it has not been possible to start many industries in India for want of adequate financial facilities, especially long-term credit facilities. Some people seem to believe that industries can only be helped by specialised institutions but the experience of foreign countries shows that this is wrong. The ordinary commercial banks can prove very useful especially if they combine into syndicates. Special Industrial Banks may be necessary, especially to finance small-scale industries. Such banks should be started privately but the Government must insure them against possible losses.

A concrete step in the right direction has been taken by the Government in setting up the Industrial Finance Corporation. It has been started with an authorised capital of Rs. 10 crores, only half of which has been called up so far. The capital has been subscribed by the Central Government, the Reserve Bank, the Scheduled Banks, insurance companies and the co-operative banks. The Corporation will give loans to industrial concerns and co-operative societies either in Indian money or in foreign currency and may raise funds in other countries for financing Indian industries.

The Indian Companies Act of 1913 and 1936. The Indian Companies Act as amended in 1936 defines a banking company as one whose 'principal' business is to accept deposits on current account or otherwise subject to withdrawal by cheque, draft or order. Such companies are required to keep as cash reserve 1½ per cent of their time liabilities and 5 per cent of their demand liabilities. They are also required to carry 20 per cent of their annual profits to the reserve fund until such fund is equal to their paid-up capital. The Act also recognises the legal status of the scheduled banks.

The need for a separate banking act has always been very keenly felt. After making a number of futile attempts to introduce a comprehensive legislation, the Banking Companies Act was passed in 1949. It was slightly modified in 1950 and, in its present form, it gives the Reserve Bank of India wide powers of control and supervision over banking companies.

Socialisation of Banking. The demand for the socialisation of banking has become very vocal in recent years. The socialists regard it as an essential step towards industrial development and economic planning. Other advocates of socialisation would, however, be satisfied if the central bank alone is nationalised or is brought under the control of a statutory corporation which would pay due regard to the interests of business.

If the central bank has to act in the interests of the public regardless of profits or politics, it must be administered by competent persons under the control of the Government. The State should lay down broad matters of policy and leave the details to be worked out by the bank officials themselves.

The case of state control over deposit banks, however, is not quite so strong. Such a step may scare away the depositors who wish to conceal their financial position from the Government and may deprive small industries of an opportunity of borrowing money against their not-so-sound assets. Some of these fears are, however, baseless and would disappear if after nationalisation all the banks are reorganised in a series of closely related banking institutions specialising in particular types of finance.

Nationalisation of the Reserve Bank. Acting on the example of other countries, the Government of India also nationalised the Reserve Bank. It is hoped that many defects which crept into the working of the Reserve Bank will now be removed. The question of nationalising the Imperial Bank is, however, more complicated and will require detailed examination of the numerous points involved.

Review of Banking in India. The existing banks are mainly of commercial type, unconcerned with public utility or wealth-creating activities. Their number is too few for the size and resources of the country and the branches are largely confined to a few States only. They also suffer from defective organisation and management and follow policies which leave scope for much improvement.

QUESTIONS

1. What is the difference between a modern bank and an indigenous banker? Enumerate all kinds of business that the latter transacts. [U. P. Inter., 1931]

2. An indigenous banker has been described by some as 'Shylock' and a 'blood-sucker' and by others as the friend of the people. With which of the two views do you agree? Give reasons for your answer. [Delhi Inter., 1934.]

3. Indicate the place of Exchange Banks in the Indian banking system and describe the nature of the work which they perform. [Punjab B.A., 1928]

4. Enumerate the causes of the amalgamation of the Presidency Banks into the Imperial Bank of India. [Delhi Inter., 1930]

5. Discuss the relative importance of the indigenous bankers, joint-stock banks and the Imperial Bank in the banking economy of the country. [U. P. Inter,, 1932]

6. What are the chief functions performed by banks working in India? What reforms would you suggest for promoting banking development in the country? [Agra B.A., 1932 and 1934; Delhi Inter., 1934]

7. Distinguish indigenous, co-operative and joint-stock banks from one another so as to bring out their peculiar features in relation to aims, constitution and working. [Punjab B.A., 1929]

8. India is said to be backward in the matter of banking facilities. Explain this statement and account for the backwardness. [Delhi B.A., 1931 and Inter., 1932]

9. What are the principal functions of a Central Bank? On what lines should such a bank be established in India? [Agra B. A., 1935]

Or

Describe the need and objects of credit control. How does a central bank control credit?

10. Discuss the advantages of a Central Bank for India. How far do you think, would the Reserve Bank of India be able to discharge those functions?

11. Discuss the arguments for and against a State Bank for India. [Delhi Inter., 1929]

12. Compare and contrast carefully the functions of a Central Bank with those of an ordinary (joint-stock) commercial bank. To what degree does the Imperial Bank of India fulfil the functions of a Central Bank?

13. Give a brief summary of the Reserve Bank of India Act, 1934.

14. Write brief explanatory notes on :—

(a) Sahukari and Sharafi System. [U.P. Inter., 1932]

(b) Co-operative Banks.

(c) Postal Savings Bank.

(d) Land Mortgage Banks. [Agra B.A., 1934]

15. What are the special features of agricultural finance? Why are the ordinary joint-stock banks unable to make adequate provision for such finance in India? Is presence of the Reserve Bank likely to make any difference?

[Agra B. Com., 1941]

16. How are industrial concerns usually financed in India? In what way do these facilities fall short of what they are in European countries? What changes in the banking structure would you suggest to promote industrial development in this country? [Agra B. Com., 1940]

Or

Write a note explaining the functions and working of the Indian Industrial Finance Corporation, 1948.

17. Discuss the case for Nationalisation of Banking in India. Should the Reserve Bank of India also be nationalised? Give your reasons. [Agra M. Com., 1947]

18. Explain the effects of Partition on banking in India.